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EDITOR'S NOTE

The papers from Cato's Moscow conference—**Transition to Freedom: The New Soviet Challenge**—will appear in the next issue of the *Cato Journal*, volume 11, number 2.

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Government Intervention in Health Care Markets and Health Care Outcomes: Some International Evidence

Rexford E. Santerre, Stephen G. Grubaugh, and Andrew J. Stollar

Introduction

Continual and significant price inflation has characterized the health care sector of the United States since the 1960s. In turn, the rising medical prices have contributed to increased health care costs. In fact, aggregate health care expenditures in the United States increased from 5.2 to 10.6 percent of gross domestic product (GDP) from 1960 to 1985 (OECD 1990). For the most part, policymakers have responded by advocating more competition in health care markets or increased regulations (e.g., the diagnosis related groups system for hospitals and relative value scales for physicians)[1] as a way of mitigating the spiraling medical care expenditures.

At the same time, policymakers have become increasingly concerned that growing competition between health care providers and various regulations might lead to unwanted reductions in the quality of medical care, as health care providers respond to the market and regulatory incentives to contain costs (Shortell and Hughes 1988). The double-edged sword of higher medical prices and lower quality of care has alarmed and dismayed many influential groups in the United States. Attempting to shield themselves, many industry groups have called on government to shoulder more responsibility for health care financing whereas government, on the other hand,

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[1]See Hsiao et al. (1988).

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has considered mandating that employers share much of the financial burden (Stevens 1989, Wilensky 1989).

In response to the attempt to pass the health care buck, a number of physicians in the United States have endorsed a national health care program along the lines of the Canadian national health insurance program or the national health care system of Great Britain (Himmelstein and Woolhandler 1989). Many argue that a national health care program can simultaneously contain medical prices and ensure an acceptable quality of care. For example, Himmelstein and Woolhandler point out that health care expenditures, as a fraction of GNP, are much lower in Canada (8 percent) and Great Britain (6 percent) than in the United States (nearly 11 percent). Despite those relatively lower health expenditures, however, Himmelstein and Woolhandler (1986, p. 444) note that "within a decade of the introduction of free access, a sharp decline in mortality occurred, so that the current levels in both Canada and Great Britain are slightly lower than those in the United States."

This paper examines government involvement in health care from both a theoretical and empirical standpoint. From a theoretical perspective, government involvement in health care matters may have an adverse impact on the quality of care. Numerous analyses of other sectors of the economy have found that both the quantity and quality of output suffers from public intervention and regulations. In particular, analysts use the postal system, local schools, rent control laws, and the pre-deregulated transportation sector as prime examples of areas in which government enterprise and regulations have inhibited efficiency (Baumol 1989). Moreover, Canadian policymakers have recently begun to question the desirability of their own health care delivery system (Brown 1989, Doherty 1989).

From an empirical standpoint, the Himmelstein and Woolhandler view may be flawed because they draw their policy conclusions from a few limited and, perhaps, unrepresentative observations (i.e., the Canadian and British national health care programs relative to the health care system of the United States). Clearly, more than a few observations are required to draw a meaningful conclusion about the relationship between government involvement in health care and the performance of the health care sector. Also, other determinants of health care outcomes, such as real GDP must be held constant before any proper conclusion can be drawn about the isolated pairwise correlation between government intervention and health care outcomes. Given the theoretical and empirical concerns, this paper systematically examines how government involvement in health care has affected infant mortality and health care costs.

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Government Intervention and Infant Mortality

To determine the effect of government on the performance of the health care sector, we examine differences in infant mortality in 20 countries that belong to the Organization for Economic Cooperation and Development (OECD) during the six adjacent half decades from 1960 to 1985. (We will provide an appendix containing the sources of all our data upon request.) Those countries are relatively homogeneous in terms of their stage of economic development and real per capita income, which allows for a systematic comparison. Government intervention in the health care sector is measured by the fraction of health care expenditures that is financed by the public sector at all levels of government. While it would be ideal if the countries could be classified under various categories or arranged into a continuum based on the degree to which their health care systems are nationalized or regulated, that is a very difficult and subjective task. In any case, ample precedent supports an expenditure ratio of the kind used here as a measure of government involvement (Borcherding 1985, Mueller and Murrell 1986).

We focus on differences in infant mortality rates as a relative measure of health care sector performance for four reasons. First, data are readily available. A more encompassing measure of health care outcomes, such as morbidity, is unavailable. Second, compared with adult mortality, infant mortality possesses a greater economic significance in terms of forgone production. Third, infant mortality is influenced much less by behavioral decisions, unlike teenage or adult mortality. Fourth, government health care policies would seem to have a greater impact on mortality during infancy, especially during the neonatal period. For example, establishing more intensive care units in selected hospitals that service high-risk infants could be accomplished relatively easily.

In Table 1, we have listed the government's share of total public and private health care expenditures, total health care expenditures as a fraction of GDP, and infant mortality for each OECD country in our sample during 1985. At the bottom of the table, we also show the average figures for those variables. The statistics for the United States are of particular interest. The U.S. government is responsible for a very low share of all health care spending (41.8 percent). That percentage is by far the lowest expenditure share of all OECD countries. Moreover, the infant mortality of 10.6 deaths per 1,000 live births in the United States is higher than the 9.4 average infant deaths for all OECD countries. That is despite the fact that health care spending as a percentage of GDP in the United States is well above the average for all OECD countries.

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TABLE 1

GOVERNMENT SPENDING, HEALTH CARE EXPENDITURES, AND INFANT MORTALITY, 1985

Country	Government's Share as Percentage of Health Spending	Health Expenditures as Percentage of GDP	Infant Mortality Rate (per 1,000 Live Births)
Australia	71.9	7.0	9.9
Austria	66.7	8.1	11.2
Belgium	76.9	7.2	9.4
Canada	74.7	8.5	8.0
Denmark	84.5	6.2	7.8
Finland	78.7	7.2	6.3
France	76.9	8.5	8.1
Germany	78.0	8.2	8.9
Greece	81.0	4.9	14.1
Ireland	88.8	8.0	8.9
Italy	78.8	6.9	10.9
Japan	72.3	6.6	5.5
Netherlands	76.2	8.2	6.9
New Zealand	85.2	6.6	10.8
Norway	96.3	6.4	8.5
Portugal	56.8	7.0	17.8
Spain	71.5	6.0	9.1
Sweden	91.1	9.4	6.8
United Kingdom	86.7	6.0	9.4
United States	41.8	10.6	10.6
Average	76.7	7.4	9.4

SOURCE: OECD (1990).

To take into account the various factors influencing health care outcomes, we examine the relation between government intervention and infant mortality by using multiple regression analysis and relying on production theory to guide the selection of our specific variables. Health economists, including Auster, Leveson, and Sarachek (1969), typically specify a health production function and include various factors, such as income, lifestyle, environmental variables, and medical services that influence health outcomes. We modify and extend the typical production function by incorporating a measure that represents the government's involvement in health care markets.

As control variables, we specify a time trend over the six half decades, real GDP per capita, quantity of medical services, percent-

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age of population that is urbanized, female labor force participation rate, and education level in each country. Taking on a one or zero value, dummy variables for each country are also specified in the multiple regression equation to control for other national differences (e.g., diet, medical technology, and climate) not captured by the other independent variables. No dummy variable is used for the United States so that the net effect of all country-specific differences is measured relative to the United States.

By using economic theory and the results of previous empirical studies, the expected signs of the multiple regression coefficients can be inferred for several of the explanatory variables. We have no a priori expectations concerning the expected sign of the coefficient on the government term. A strong argument could be made for either a beneficial (negative coefficient estimate) or adverse (positive coefficient estimate) impact. On the one hand, greater government involvement in or financing of health care may provide individuals who are unable to pay greater access to health care. Since those individuals would otherwise consume relatively small amounts of medical services because of financial barriers to access, medical services for low-income individuals should be able to generate good health. Hence, mortality rates would tend to decline with greater government financing of health care.

On the other hand, greater government involvement in health care may come at the cost of excessive regulations. Excessive regulations may adversely affect the total output (quantity and quality) of physicians and other health care providers. For example, if government uses its monopsony power to reduce prices of medical services and wages of health care employees, shortages of medical services might result. Those shortages would lead to higher mortality rates. Indeed, the theory of public choice (Brennan and Buchanan 1980), the theory of government enterprise (Ahlbrandt 1973), and the theory of economic regulation (Stigler 1971) all suggest that more government involvement is very likely to have an adverse, rather than a beneficial, impact on the performance of the health care sector.

The time trend variable is specified because panel data are used. Fuchs (1986) notes that mortality rates may decline over time with advances in knowledge and technology. Real GDP per capita controls for differences in nutrition and home environment, among other factors, and thus, theoretically, higher GDP per capita should lead to lower infant mortality.[2] Increased medical services should also

[2]Real GDP and real health expenditures in U.S. dollars are determined by dividing the nominal values by the GDP deflator and converting with the 1980 U.S. dollar exchange rate.

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lead to lower mortality rates as long as the marginal productivity of medical services is greater than zero. Real health care expenditures per capita and physicians per capita act as proxy variables for medical services in two separate regression equations.

Greater urbanization might lead to lower infant mortality because the greater compactness and lower transportation costs in urbanized areas result in greater access to medical care. However, pollution and other environmental concerns might impose greater health hazards in urban environments. The female labor force participation rate also controls for two opposing effects. A higher female labor force participation rate may mean less home health care and a higher infant mortality rate, or it may mean increased income in two-wage-earner families and a lower infant mortality rate. While the female labor force participation rate of married women is preferred to test those hypotheses, data of that kind are unavailable.

Finally, the efficiency of home health care is captured by the education level in the country. Greater efficiency in home health care should lead to lower infant mortality. The number of teachers per pupil at the primary level serves as our proxy for educational differences across countries since it captures the resource commitment and priority given to education. Data for a more direct measure of educational attainment are unavailable. All variables are expressed as natural logarithms. The ordinary least squares technique is used to estimate the health care production function.

In Table 2, columns 2 and 3 report the regression results of estimating the production function with health care expenditures per capita (Regression 1) and physicians per capita (Regression 2) as alternative measures of medical services. The empirical results suggest that greater government involvement has no impact on infant mortality since the estimated coefficient on the government variable is not statistically different from zero at conventional levels of significance. The estimated coefficient is positive but only significant at the 20 to 25 percent level. Clearly, the results lend no support for the Himmelstein and Woolhandler point of view that greater government involvement reduces mortality, at least not among infants.

However, other factors do significantly influence infant mortality. Increases in real GDP are associated with a reduction in infant mortality. Since all variables are expressed in logarithms, the estimated coefficient on each variable can be interpreted as an elasticity. As a result, a 10 percent increase in real GDP per capita causes a 6.5 to 8.9 percent decrease in infant mortality. The empirical findings also imply that a greater quantity of medical services leads to a decrease in infant mortality. Specifically, a 10 percent increase in health care

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TABLE 2

INFANT MORTALITY REGRESSIONS

Independent Variable	Parameter Estimate (Absolute Value of the *t*-Statistic)	
	Regression 1	*Regression 2*
Intercept	9.02[a] (5.71)	3.93[b] (2.60)
Government's Share of Health Care Spending	0.166 (1.40)	0.127 (1.30)
Time Trend	−0.569 (0.65)	−0.069 (1.11)
Real GDP	−0.650[a] (2.73)	−0.892[a] (6.83)
Medical Services Real Health Care Expenditures	−0.328[b] (2.09)	
Physicians per Capita		−0.539[a] (6.89)
Urbanized Population	0.433[b] (2.16)	0.707[a] (4.21)
Female Labor Force Participation Rate	−0.015[a] (4.45)	−0.004 (1.21)
Education	−0.042 (0.594)	−0.135[b] (2.34)
	+ 19 country dummy variables	+ 19 country dummy variables
Adjusted R^2	.931	.954
Number of Observations	110	110

[a]Significant at the 1 percent level or better.
[b]Significant at the 5 percent level.
NOTE: All continuous variables are expressed in natural logarithms.

expenditures per capita causes infant mortality to decline by 3.3 percent. Similarly, a 10 percent increase in the number of physicians per capita leads to a 5.4 percent decline in infant mortality.

In addition, urban environments are associated with greater infant mortality since the estimated coefficient on the urban variable is positive and statistically significant in both regressions. Increased education is associated with a lower infant mortality rate, as expected.

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The estimated coefficient on the education variable is negative in both regressions. However, the coefficient on that same variable is not statistically different from zero in the first regression equation. The inverse relation between those two variables may confirm that better educated individuals are more efficient at producing home health care or that both types of human capital investments, education and health, are complementary.

Last, a higher female labor force participation rate is associated with lower infant mortality. The estimated coefficient is negative in both regressions and statistically significant in one of them. Apparently, the higher family income that results when females enter the labor force more than offsets the possible adverse effect of fewer home health care services and causes the infant mortality rate to decline.

Although not shown in Table 2, it is interesting to note that most of the country dummy variables possess negative and significant coefficient estimates. That means that other OECD countries have a significantly lower infant mortality rate than does the United States, after holding other influences on infant mortality constant. That finding indicates that country influences, specific to the United States, have an adverse impact on infant mortality. Those country-specific influences are factors other than government intervention, income, medical services, education, female labor force participation rate, and degree of urbanization.

Because country-specific influences are so important, an additional method of specifying their effects was followed. Rather than specifying country-specific factors by simply using the qualitative zero-one dummy variable (called the fixed-effect model), we allowed the country differences to vary randomly over the different time periods. Balestra and Nerlove (1966) and Maddala (1971) refer to that method as the random-effects or error-components model. That method should give more precise estimates of all the estimated coefficients if the assumptions of the random-effects model are satisfied (that the country-specific effects are independent, identically distributed random variables with mean zero and a common variance). Following Hausman's (1978) suggested technique, we tested and rejected those assumptions and, thus, conclude that it is more appropriate to use the fixed-effect model.

Government Intervention and the Containment of Health Care Costs

Another possible benefit of government intervention in health care markets is cost containment. We use regression analysis to analyze

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this issue. Specifically, we regress the logarithm of total health care spending per capita on the logarithm of the following variables: government health care expenditure share, a time trend, real GDP per capita, percentage of urban population, female labor force participation rate, level of education and population, and country dummy variables.

According to Himmelstein and Woolhandler (1986), government financing eliminates most of the administrative overhead and waste associated with private health insurance. In addition, government can use its monopsony power to contain the prices of medical services when it controls a greater share of health care spending. Given these two considerations, the basic hypothesis is that greater government financing of health care spending leads to lower total health care costs. An alternative hypothesis is that government lacks a profit incentive to minimize health care costs (Ahlbrandt 1973). It follows that health expenditures will be higher when government controls a greater share of health care spending, other things being constant. For the sake of brevity, the expected relation between the other control variables and health care spending is not discussed. The regression results are shown in Table 3.

The results fail to support the basic hypothesis that greater government financing leads to a lower level of health care spending. In fact, the coefficient estimate on the government variable is positive rather than negative, although not statistically different from zero. The findings suggest that government is unable to contain health care costs, even with increased control over the health care purse strings. The results also lend no support for the alternative hypothesis that greater government financing leads to excess health care spending. Evidently, government has no net impact on overall health care costs, at least for this particular sample of OECD countries.

The results indicate, however, that per capita health care spending increases with real GDP. In particular, a 10 percent increase in real per capita GDP causes an 11 percent increase in health care per capita spending. Apparently, aggregate health care spending is highly responsive to changes in national income. Furthermore, the findings imply that health care spending has increased over time, perhaps reflecting the growth of cost-enhancing technologies in this sample of developed countries. Health spending is also found to be positively related to the level of education. Not surprisingly, those two forms of human capital investment, education and health, are positively correlated.

Conclusion

Our results raise serious doubt about the desirability of a national health care program in the United States. Evidently, government

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TABLE 3

HEALTH CARE EXPENDITURE REGRESSION

Independent Variable	Estimated Coefficient (Absolute Value of the *t*-Statistic)
Intercept	−4.06[a] (3.79)
Government Share of Health Care Spending	0.008 (0.096)
Time Trend	0.287[a] (5.61)
Real GDP	1.11[a] (10.1)
Urbanized Population	−0.003 (0.019)
Female Labor Force Participation Rate	−0.004 (1.87)
Education	0.095[b] (1.98)
Population	0.000003 (1.57)
	+ 19 country dummy variables
Adjusted R^2	.985
Number of Observations	110

[a]Significant at the 1 percent level or better.
[b]Significant at the 5 percent level.
NOTE: All continuous variables are expressed in natural logarithms.

is unable to influence infant mortality or control total health care spending. But what about other roles for government in the health care sector?

Perhaps government can indirectly improve the performance of the health care sector by creating an environment that allows the macroeconomy to function properly. Our results indicate that infant mortality is greatly influenced by higher levels of real GDP. The more favorable socioeconomic conditions associated with higher levels of income apparently lead to better health care outcomes. If so,

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ensuring macroeconomic growth is a good strategy for lowering infant mortality.

Alternatively, from a microeconomic perspective, the government might encourage the allocation of inputs to the medical services industry. Our empirical study also finds that more abundant medical services cause infant mortality to decline by a substantial percentage. Certainly, the government should not adopt regulations that negatively affect the quantity and quality of medical inputs. Some health economists view the diagnosis related groups system and relative value scale scheme as regulations of that kind.

From a slightly different microeconomic perspective, the government can help foster better health through education. The results suggest that better educated populations are associated with lower infant mortality rates. Indeed, the recent campaign to wipe out illiteracy in the United States could, if successful, have a tremendous impact on infant mortality. Furthermore, local schools might devote more resources to health education.

Of course, more studies are needed before any empirical generalizations can be made and policy implications can be safely drawn. Our suggestions for an appropriate government role are cautiously prescribed, and we eagerly await other opinions. Future studies should attempt to untangle the effects of government financing and production on the performance of the health care sector. Providing free access to private medical care, as does the Canadian health care system, may have an impact different from that of the national health care system of Great Britain, where production is nationalized. In our study, we were unable to separate and measure the differential impacts of these two kinds of health care programs. It is hoped that other researchers will pursue that fruitful line of inquiry.

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The Dismal Fate of Soviet-Type Economies: Mises Was Right

Gertrude E. Schroeder

Introduction

The economies of the Soviet Union and Eastern Europe are socialist economies as defined by Karl Marx, Ludwig von Mises, and the *New Palgrave Dictionary of Economics*. According to the latter, "A society may be seen to be a socialist one if the major part of the means of production of goods and services are not in private hands, but are in some sense socially owned and operated, by state, socialized, or cooperative enterprises."[1] For Mises, public ownership of the means of production destroyed the very essence of a market economy—a mechanism for valuing the scarce factors of production used to serve society's wants, so as to satisfy those ever-changing wants at least cost. Efficient valuation of scarce factors, Mises argued, requires private ownership of land and capital, because it is the owners who can best assess the risk/reward balance in evaluating and choosing future endeavors. Since their own capital is at risk, owners have the maximum incentive to make the correct choices among many that are possible and also to monitor carefully the actions of the managers to whom, in the modern world of large-scale organizations, the owners must necessarily delegate authority. Mises (1967, p. 106) foresaw with uncanny prescience the consequences of attempts to create an economic order based on pervasive public ownership of property: "In place of the economy of the 'anarchic' method of production, recourse will be had to the senseless output of an absurd apparatus. The wheels will turn, but will run to no effect."

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[1]Alec Nove, "Socialism," in *The New Palgrave* (1987, p. 398).

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The results of over 70 years of experience in the Soviet Union with a socialist economic order and of more than 40 years of such experience in six countries in Eastern Europe allow us to judge the accuracy of Mises's forecast.

Institutions of the Soviet-Type Economy

All seven countries—the USSR, Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania—adopted a similar set of economic institutions. Briefly, they are the following: public (predominantly state) ownership of land and capital; administrative allocation of land and capital by government bureaucracies; dictation of the product mix by means of detailed plans directed to individual firms and farms; administratively set and infrequently changed prices; business firms that operated on formal profit-and-loss accounting rules but also were subordinated to government agencies (ministries); incentives related to jobs and oriented toward meeting one or several specific plan targets; and quasi-markets for labor and in household consumption. Despite a plethora of so-called reforms over the years, these institutions proved remarkably durable, at least in essence, if not in detail. It is these socialist institutions, replacing the market, that have shaped the behavior of the business firms and their workers. Their behavior, in turn, has been the major determinant of the economic outcomes observed in all countries.

Besides these institutions, the economic outcomes in Soviet-type economies have been shaped by a common development strategy, chosen by Stalin for the USSR in the late 1920s and imposed by him on Eastern Europe in the late 1940s. In the service of the state planners' goal of rapid industrialization, these countries adopted a grossly unbalanced growth model, allocating disproportionate shares of resources to investment rather than to consumption, to industrial investment rather than to agriculture and services, and to heavy industry (producer goods) in preference to consumer goods. While not necessarily inevitable under a socialist order, this development strategy was a logical choice, once the state, rather than markets and consumers, took charge of the allocation of capital and the determination of the bill of goods.

The Experience of Soviet-Type Economies

The experience of all seven countries under socialism displays a common pattern. Measured economic outcomes are similar, as are the revealed problems, and so are the underlying causes. Mises (1947, p. 83) summed it up succinctly: Socialism "will squander the

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scarce factors of production, both material and human. Chaos and poverty for all will unavoidably result." While some people may regard this as an overstatement, few if any of them are to be found among today's reformers in the Soviet Union and Eastern Europe.

Economic Growth

Socialist countries proved capable of obtaining growth rates for both GNP and GNP per capita that, on average, did not differ significantly from those in OECD countries. Such was the finding of an econometric analysis made by Frederic Pryor (1985) for the years 1951–79. Although industrial production rose somewhat more rapidly in the East than in the West, other nonagricultural sectors grew more slowly. But retardation in growth was more pronounced in the East. In the 1980s, however, growth was markedly slower in the East. During 1981–89, GNP increased at an average annual rate of 1.7 percent in the USSR and Eastern Europe, compared with growth in developed Western countries at an annual average of 3.0 percent.[2] A similar picture is shown by data on growth of GNP per capita. Clearly, the growth process in the East was bogging down.

Productivity

Pryor's work also showed that rates of growth in factor productivity (dynamic efficiency) were lower in the East than in the West, and retardation in productivity growth in the East was more pronounced. Although rates of growth of labor productivity in the East compared rather favorably with those in the West, they, too, have slowed markedly. Since investment shares in GNP were generally higher in the East, the investment costs of economic growth have been higher there, and the consequent squeeze on consumption has been greater. Socialist growth was fueled by rapid mobilization of labor and capital, and expansion of factor inputs provided the overwhelming bulk of growth of GNP (except in East Germany). This "extensive" growth model had become increasingly unviable, as labor force participation ratios reached a near maximum, population growth slowed, and marginal productivities of capital declined. In a growth accounting framework, the failure of the socialist system to generate offsetting productivity gains helps to explain the strong retardation in economic growth. Using this framework, Abram Bergson (1989, p. 22) found that levels of GNP per worker in socialist countries were lower by 25 to 34 percent than those in OECD countries, when allowance is made for differences in capital per worker and labor is adjusted for

[2]Central Intelligence Agency (1990, pp. 36–37).

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hours, quality, and education; he attributes this difference largely to systemic factors.

The "squandering" of scarce resources in socialist countries has been revealed in many other studies. Thus, John Moroney (1990, p. 212), using data for the late 1970s, finds that energy consumption per unit of real product and per unit of capital was twice as high, on the average, in the CMEA countries (USSR and Eastern Europe) as in Western Europe. Moreover, the East has relied to a much greater extent on energy relative to capital as a source of growth than has the West. Moroney's findings are consistent with those of other investigators. Gomulka and Rostowski (1988, p. 491) find that CMEA countries had higher intensities in the use of raw materials, especially energy, than does the West and that these "gaps" have been increasing. Other aspects of efficiency could be addressed. The poor quality and design of products manufactured in the East is indicated by a mass of anecdotal evidence of consumer dissatisfaction, by the technological backwardness of the capital stock, and by the poor salability of manufactures to Western markets, not to mention the perennial complaints of CMEA members about the quality of one another's products that enter their mutual trade.

Shabby Living Standards

To quote Mises (1947, p. 54), once more, "Communism is a feature of backward countries and results in general poverty." Living standards in the USSR and Eastern Europe, even after decades of industrialization, are low by comparison with Western Europe, and the gaps have been widening overall, especially in the past two decades.[3] Although at present an intense controversy rages over the quantitative levels of per capita consumption in the socialist countries relative to the West, it is clear, nonetheless, that as a group they are among the poorest countries in Europe, ranking above Turkey, but well below even such countries as Austria, Spain, and Portugal. Czechoslovakia has been unable to keep pace with Austria by a wide margin, East Germany with West Germany, and the USSR even with Portugal. The causes of the relatively low levels and widening disparities in per capita consumption between East and West are to be found in the relatively low shares of consumption in GNP in the Eastern countries, in the high investment costs of their growth, and in the low productivity of their workers.

Such quantitative assessments of relative living standards in the socialist countries considerably overstate both their progress relative

[3]See, for example, Schroeder (1987).

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to Western market economies and their present comparative levels. This is so, because in the West the increased flow of goods and services has been accompanied by a concomitant flow of retail trade services, while such was not the case in the East; there, the governments for decades skimped on investment in the retail sector in particular and in consumer-oriented infrastructure in general. Moreover, the measures of quantitative levels of per capita consumption do not capture other aspects of consumption that affect people's welfare. To acquire the goods and services that the measures try to estimate as accurately as possible, consumers in socialist countries had to cope with pervasive but random queues (lines or waiting lists), were forced to go from store to store to find desired items, and had to face disequilibrium prices. These phenomena entail sizeable welfare losses for consumers in the East, relative to their Western counterparts. Finally, the quantitative measures cannot reflect completely the relatively much greater variety, better packaging, and more attractive design and fashion of products, not to mention the more pleasant service generally prevailing in the West, where providers must cater to consumers' wants in order to survive.

Income Distribution

A common claim for socialism is that such a system, having eliminated the incomes from private property ownership, will result in a much more egalitarian distribution of personal incomes than is to be found under capitalism. The data needed to assess this important matter leave much to be desired for all countries. Nonetheless, using such data as are at hand, Bergson (1984) in an exhaustive survey for the USSR finds that the distribution of income there was well within the range for capitalist countries and most closely resembles that in such countries as Norway and the United Kingdom. Christian Morrison (1984), taking into account not only money incomes, but also incomes in kind and the value of perks, finds that income distribution in the socialist countries of Eastern Europe was not more egalitarian than in capitalist countries. Specifically, he finds two groupings among countries in each system—a group with relatively less egalitarian distributions as measured by Gini coefficients and a group with relatively more egalitarian distributions. Finally, with regard to earnings differentials between men and women, Moroney (1979) concludes that the overall earnings shortfall for women was about the same under both economic systems.

Root Causes of Poor Performance in Soviet-Type Economies

Two fundamental factors are at the root of the poor performance of socialist countries relative to their capitalist counterparts. The first

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is the pervasive faulty valuation of the factors of production and of their products. Socialist states have had to sail the economic seas like ships without compasses. Mises (1937, p. 122) put it thus:

> And then we have a socialist community which must cross the whole ocean of possible and imaginable economic permutations without the compass of economic calculation. All economic change, therefore, would involve operations, the value of which could neither be predicted beforehand nor ascertained after they had taken place. Everything would be a leap in the dark. Socialism is the renunciation of rational economy.

And again (Mises 1947, p. 83):

> A socialist management of production would simply not know whether or not what it plans and executes is the most appropriate means to obtain the ends sought.

Mises's basic argument is that with social ownership of land and capital there cannot be markets for those factors of production. Without markets for them, these scarce factors cannot be priced so as to reflect their values in alternative uses and their changing relative scarcities. All monetary price tags that the monopoly owner—the state—may attach to the factors of production in practice can only be arbitrary. Without rational prices for all factors used in their production, the products (both intermediate and final) also cannot be efficiently priced.

In practice, the Soviet-type economies found product pricing to be a perennial problem. For the most part, land was not valued at all and was not taken into account in the pricing of goods. Capital costs were recovered mainly by inclusion of administratively set depreciation charges in the average labor costs (past and present) that underlie the prices of all products. Such an approach derives from Marxian value theory. Although details vary among countries, the essential features are the following.[4] Producer prices for all goods are calculated as average, branch-wide costs of labor and materials plus an arbitrary profit markup. Prices were changed periodically to reflect accumulated changes in those costs and planners' decisions about the size of markups. Consumer prices were determined by adding to their prime cost the applicable distribution markups and taxes (or subsidies). In practice, retail prices contained large taxes on so-called luxuries (alcoholic beverages, clothing, and durables) and large subsidies on food and rents. Clearly, such prices reflect neither opportunity costs for producers nor relative utilities for consumers. They distort the perceptions of planners and enterprises even to the lim-

[4]For an excellent summary for each country, see Marer (1985, pp. 120–64).

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ited extent that they are used to guide choice, and they skew the pattern of demand of consumers. The pricing factor alone produces a world of crooked mirrors in socialist economies.

The second fundamental consideration underlying the poor performance of socialist economies is the system of incentives. To quote Mises (1967, p. 116), "The exclusion of free initiative and individual responsibility, on which the successes of private enterprise depend, constitutes the most serious menace to socialist economic organization." To begin with, collective ownership deprives the socialist economy of the incentives for efficiency that derive from private owners' striving to enhance the worth of assets, along with the value of the income stream from their use. Moreover, socialism in practice has abolished competition among business firms, substituting the farce of "socialist competition" oriented toward overfulfilling plan targets of one kind or another. Profit seeking has not been made the primary goal of socialist managers, and even if it had been, the distorted prices for both inputs and outputs that managers face necessarily would deprive accounting profits of economic meaning.

Having eschewed the "stick" of competition and the "carrot" of profit seeking as incentives for producers, socialist planners were forced to devise suitable substitutes. The problem has proved to be insoluble. In practice, managerial rewards were tied in one way or another to meeting plan targets for production in physical or value measures. Other plan targets, such as profits or productivity indicators, tended to have secondary priority in the administration of incentive schemes. Because firms were subordinated to government agencies, which appointed managers and administered the rules of the game, the incentives for managers of socialist business firms came to resemble those of employees in a bureaucracy.[5]

In the final analysis, it is the behavior of the business firms and their workers that determines final economic outcomes in any economic system. It is they who engage in production and exchange, which are the essence of the economic process. Responding to the system of incentives and the flawed valuations of inputs and outputs that it faced, the socialist business firm displayed a unique but universal behavioral pattern.[6] The socialist firm does not have to "sell" its product or "buy" its materials, because products are "distributed" and raw materials are "allocated" by central authorities. Similarly, the firm does not have to seek out investors and lenders, because capital goods and bank credits, too, are allocated administratively.

[5]For an elaboration of this argument, see Greenslade and Schroeder (1977).
[6]See, for example, Berliner (1957); Granick (1954, 1975); Jeffries (1981).

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The socialist firm's position thus became one of extraordinary security; it never faced bankruptcy, but instead could count on being rescued by its superiors in the administrative hierarchy if things went wrong (Kornai's "soft budget constraint").

The resulting behavioral pattern of business firms is found in all of the socialist countries. The firm displays a short-term orientation. It juggles its product mix in the service of the particular arrangements it faces, often to the detriment of the interests of customers. It searches for safety factors, so as to ensure meeting plan targets; by understating its production potential, seeking easy quotas, and hoarding materials and labor. It neglects "secondary" assignments such as improving the quality of products and raising worker productivity. Finally, and perhaps most critical of all, it seeks to avoid risk, eschewing innovation "as the Devil shies away from incense," as the former Soviet leader Leonid Brezhnev once put it.[7] Indeed, this drag on innovation at the level of the enterprise, reinforced by the bureaucratization of the innovation process in general, goes a long way in accounting for the sluggish rate of technological progress manifested in the economic performance of socialist countries.

The Decades-Long Treadmill of Attempts to Reform Socialism

Since the debilities created by socialist institutions were visible almost from the start, the USSR and the East European countries soon embarked on a ceaseless search for solutions. Although tinkering with socialist working arrangements began in most countries in the 1950s, the search became more feverish in the 1960s, triggered by Nikita Khrushchev's brand of glasnost in the Soviet Union and spurred by the general perception that an upsurge in efficiency was imperative if the deceleration in growth was to be halted and increasingly dissatisfied populations placated. Since the mid-1960s, we have witnessed a veritable treadmill of reforms in socialist countries, as reforms were launched and then soon followed by reforms of those reforms that had failed to yield the desired results. Although the timing, details, and pace of these successive reforms varied greatly among countries, all blueprints had a common ingredient—the attempt to achieve improved economic performance without fundamentally altering the basic institutions of socialism. Innumerable changes were made in organizational forms, pricing arrangements, and the rules of the game for business enterprises. Mises (1983, pp.

[7]*Pravda*, 31 March 1971.

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194–95) predicted the outcome many decades ago: "The problems of socialization cannot be solved by civil-service instructions and reforms of organizations."

A major theme in the successive waves of reforms in most countries was the use of so-called economic levers—sales, prices, profits, bank credits, and formation of enterprise incentive funds—in an attempt to orient the socialist business firms toward pleasing customers and economizing on resources. The process was carried furthest in Hungary and in Poland. To this end, innumerable and complex changes were made in the rules of the game for enterprise managers. Their bonuses were tied to an ever-changing array of these "levers." Firms were allowed to form their "own" incentive and investment funds, retaining more of their "own" profits to do so, and were given greater latitude in making decisions about the disposition of these funds. The aim was to get socialist firms to behave like capitalist firms by aping market forms, but without giving these forms the economic content that they have in market economies and without altering the fundamental position of the firm as the property of the state. Such attempts were like trying to square the circle. They were doomed to failure. Mises (1967, pp. 120–21) put it thus:

> A popular slogan affirms that if we think less bureaucratically and more commercially in communal enterprises, they will work just as well as private enterprises. . . . [But] the entrepreneur's commercial attitude and activity arise from his position in the economic process and is lost with its disappearance . . . [a process] which allows the identification of the firm's and his own interests.

In effect, the reformers were attempting to create some species of a "market socialism." Although no country attempted to replicate the set of specific arrangements prescribed by Oskar Lange in the famous "socialist controversy" of the 1930s, the idea was that some combination of market forms and socialist property arrangements could provide a viable alternative to capitalism. In Hungary, in particular, the reforms included a concerted attempt to develop regulated markets and to encourage a variety of ownership forms in small-scale endeavors. But, as described by Kornai (1986), real markets failed to materialize, and state and collective property ownership remained overwhelmingly dominant. There, as elsewhere, the multitudinous reforms failed to arrest the deterioration in the performance of the socialist economy.

In the face of such failures and with the advent of new leaders in some countries in the early and mid-1980s, the ideologically sensitive issue of property ownership and its influence on people's behavior became a theme in the reform debates, first in Yugoslavia and

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Hungary, and later even in the traditionally orthodox Soviet Union after Gorbachev became General Secretary of the Communist Party in March 1985. The new Soviet leader began talking about the need to induce "proprietary attitudes toward socialist property" and later declared that socialist property had become "nobody's property, having no real owner,"[8] with seriously adverse economic consequences. After that declaration, the debates about the role of property ownership in the reform process took off in the USSR and elsewhere. The ownership issue has increasingly dominated the discussion in the past two years in the USSR, Hungary, and Poland, and more timidly elsewhere in Eastern Europe. Legislation permitting a diversity of forms of ownership has been adopted in several countries, including the USSR, where the particularly sensitive issue of land ownership has also been raised.

In most countries of Eastern Europe, especially following the political upheavals in 1989, and also in the Soviet Union in 1990, the twin themes of "privatization" and "marketization" now dominate the reform debates and provide the framework for reform blueprints. If laws and blueprints go far enough and if they are translated into reality, socialism as defined by Marx, Mises, and the *New Palgrave Dictionary* will cease to exist in the USSR and Eastern Europe. That, of course, is a very big "if." But after decades of experience with socialism, many people in the USSR and Eastern Europe have ceased to believe in the desirability of some "Third Way"—some species of a "market socialism"—and have joined with Mises (1937, p. 122) in his conviction that "the choice is still *either* socialism *or* a market economy."

The Terrible Legacies of Socialism

The replacement of a market economy with a socialist one that lasted over many decades has left an awesome mess for today's reformers aiming to reverse the process. Such an outcome, however, would have been no surprise to Ludwig von Mises. Reforming governments in the Soviet Union and Eastern Europe, if they stay the course, will be struggling with these legacies for a very long time, perhaps even a generation or more. The pain that will be required to overcome these shackles inevitably will strain the political process, delay implementation of reforms, and make the benefits from the new arrangements slow to come.

The most serious legacy is the fact that in all countries the state still owns the vast bulk of property, virtually all of it in the industrial

[8]*Kommunist*, no. 3 (February 1987), p. 7.

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sector. Many critical decisions must be made. Which properties are to be sold? What bundle of rights to property shall be sold? To whom? At what price? In what form shall payments be required? Moreover, to make the transferred property rights meaningful, a legal code spelling out and guaranteeing those rights must be in place. Institutions, such as stock exchanges, must be created. The evolution of a system of private property took place over many, many decades in the West. Although socialism was able to destroy private property virtually overnight, its resurrection and solidification will be a protracted process.

Associated with state property ownership is the physical legacy left by the state's gross mismanagement of society's capital. This legacy is to be seen in the huge capital stocks that have been built up in the USSR and Eastern Europe—assets that are largely obsolescent and of poor physical quality by Western standards. Socialist management has produced a distorted world—an overgrown industrial sector dominated by smokestack industries alongside seriously underdeveloped service sectors, especially commercial and business services. Factories are too large and employ far too many people, are located in the wrong places, use the wrong technologies, and are organized in the wrong way, compared with the situation that would have been brought about by market forces. Environmental damage has been inordinately great. Socialism also has bequeathed a world of monopolies to its successors. Concentration ratios are extremely high, and plants are inordinately large. A kind of gigantomania has prevailed. The extensive network of small-scale subcontracting and service firms that facilitate the manufacturing process in the West scarcely exists in socialist USSR and Eastern Europe. But the new capitalist institutions when established must begin to operate with the existing capital assets. Restructuring of industries and renovating of large capital stocks will require much time and huge new investments. From where are they to come? And how can governments cope with the large-scale unemployment and relocation of workers that is inevitable in the process?

And then there are the legacies embodied in the human capital that has been accumulated under decades of a socialist order. This legacy has a number of facets. People lack the work attitudes, education, and skills that will be required to thrive in a market economy that can compete with the West. People are accustomed to lax work effort, subsidized food and rent, full employment, and a low-grade welfare state milieu. How are attitudes and expectations to be reshaped? How shall the labor mobility required by a market economy be achieved in countries with acute shortages of housing and

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enterprise-based welfare systems? Enterprise managers trained under socialism lack the skills and "business culture" needed to compete in a market economy. Bankruptcy and competition are alien concepts, and risk taking is foreign to a socialist environment. How is a reforming government to deal with pleas for help from its formerly owned firms, especially from the large ones? Finally, there is the human capital tied up in the large bureaucracies that have been managing the socialist economy. These people have strong vested interests in the status quo and an interventionist mentality that could thwart the emergence of markets by their over-regulation. Hungary's 20-year saga of reforming its reforms is a case in point.

Finally, there are the legacies associated with the foreign trade sector. Although foreign trade participation ratios in the socialist countries tend to be low relative to capitalist countries at similar levels of development, the relatively small countries of Eastern Europe are heavily trade-dependent; the Soviet Union is less so. In recent years, these countries have conducted roughly two-thirds of their trade among themselves in a pattern dominated by the exchange of Soviet raw materials for East European manufactures and some food. Such trade has been conducted essentially on a barter basis. Because of the poor salability of all countries' manufactures in competitive markets, their trade patterns with the West resemble those of Third World countries, which predominantly export raw materials and import manufactures. Some countries have accrued huge hard currency debts to the West. Their currencies are inconvertible and their price structures are largely divorced both from domestic and from foreign scarcity relationships. As a consequence of such pricing, the existing export structures of these countries are weak and distorted in complex ways. Jan Winiecki (1988, p. 141) describes the distortions as the consequence of specializing "without knowing one's own comparative advantages." Finally, the relative isolation of domestic producers from direct contact with Western markets has left their managers without experience in selling in competitive international markets. Problems with exportability of their products may prove to be one of the greatest obstacles to integration of the socialist countries into the international order as "normal market economies"—the proclaimed ultimate goal of the current wave of reforms.

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The Nondesignability of Living Systems: A Lesson from the Failed Experiments in Socialist Countries

Jixuan Hu

Introduction

To some readers from the West, the point addressed here may seem to be just common sense. However, not all cultures share the same idea of common sense. Ideological bias may cause blindness to or misunderstandings of another culture's common sense. For instance, Western ideas cannot be accepted easily in socialist countries such as China and the Soviet Union, and vice versa, but careful scientific analysis of ideas may produce a better chance of communication between people with different ideologies. On the other hand, what appears to be common sense may be misleading. Many Westerners observe the problems in socialist countries at only a tourist's level. At such a level, phenomena are oversimplified and misunderstood. Thus, larger gaps instead of bridges of communication are created.

Designing a better or even a perfect society is one of the most persistent ideals in human history. From the time of Plato to that of Marx, and even today, finding a blueprint for a better society has been a constant goal.

The communist movement since the 19th century can be seen as an experiment in designing a better society. The core of the design is a centrally controlled social-political-economic system. Marx drew a sketch, Lenin worked out a draft, Stalin standardized the blueprint, and Mao copied most of it. People in power—Tito, Khrushchev,

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Deng, and Gorbachev—have modified it or tried to redraw it. Remarkable results have been achieved and horrible crimes have been committed under the banner of communism.

According to the old "Stalinist model," which dominated most socialist countries for years, all economic enterprises are controlled by the central state government. The government plans (designs) all aspects of the economy and the society in detail, including what and how much to produce and how raw materials and products should be allocated and transported, as well as prices and investments. Furthermore, the government requires the individual to "reconstruct his world outlook," to "learn from hero models," so as to become absolutely obedient and, thus, keep the design trouble free.

Numerous economists have pointed out that economic plans in the Soviet Union (and other socialist countries) are often unfulfilled because information flows are always distorted, plans are not perfectly designed but are only the subject of bargaining, and planners are adapting to circumstances as best they can. So the economy is not planned or designed but managed or counterbalanced (Nove 1983). As time passes, the problems of the Stalinist model become more and more obvious.

The pressure for reform in socialist countries has been stronger than the wildest expectations of the designers. Pioneer reforms occurred in Yugoslavia in the late 1950s. Hungary and Poland have also explored new models and alternatives. China started its economic reform, known as "the second revolution," in 1979. The oldest "socialist brother," the Soviet Union, began its biggest reform in 1985. Recent swift changes in East European countries have shown that more and more people have begun to admit that classic socialism does not work, that it needs to be changed. However, why it does not work and how to change it are controversial issues that remain unsolved both in theory and in practice.

All of the reforms mentioned above have at least one common characteristic: the decentralization of power or abandonment of the Stalinist model. However, some decisionmakers in the reforming socialist countries are still seeking other, presumably better, blueprints for designing their societies. Most of them think that the problems were caused by wrong or imperfect blueprints or by incorrect implementation. Thus, their efforts are devoted to modifying or redrawing the original design.

Nevertheless, theoretical failures in designing social systems are also widely noted. Works on econometrics are sometimes criticized as "the economics of paradise," which has no use for the real world. Computer socioeconomic models, no matter how sophisticated, seem

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to bring more questions than answers to the hopeful designers. Still, efforts are being made to create new designs for society. Even the methods of cybernetics and systems engineering are being used. One example is Manescu's "General Cybernetic System of the National Economy" (Manescu 1978), but that model seems not to be doing well in guiding Romania's economy. However, the ideal of a better designed society is so attractive that people keep trying.

Human ideals can be put into two categories: achievable and unachievable. Unachievable ideals can be misleading and dangerous. They are usually shown to be unachievable by developments in science. For example, the ideal of inventing "perpetual motion machines" was identified as unachievable by the law of conservation of energy in physics; the ideal of making "medicine for immortality" was rendered unachievable by the principle of function alienation in systems theory (Jin 1988).

The purpose of this paper is to analyze the ideal of designing a perfect society, or "the long term and great ideal of communism." Is it also unachievable? The principle of nondesignability of living systems presented in this paper sheds some light on the answer. The paper is divided into five sections. Section one will offer a definition of design, clarifying the four elements needed for any successful design. Section two will explore six specific characteristics of society, referring to some new developments in systems theory, and will present a social uncertainty principle. The discussion in section three will be the main point of the paper: Living systems such as societies and human minds are not designable in an engineering sense. In section four, I shall briefly describe several pathological phenomena, which are the consequences of forcibly designing the undesignables, in socialist countries. The concluding section will propose an epistemological change to new ways of thinking.

What Do We Mean by Design?

This section will first clarify the meaning of design: A definition will be generated based on the four basic elements of design. Then I shall discuss some immediate implications of the logic of designing a society and shall raise the question of whether or not everything in a society can be designed.

Definition by the Four Elements of Design

The ordinary meaning of "design" is fuzzy. In English its synonyms include to plan, to make a blueprint, to purpose, to cast, to project, to map out, to devise. The common meaning of the verb

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"design," according to *Webster's Ninth New Collegiate Dictionary*, is "to conceive and plan out in the mind; to have as a purpose; to devise for a specific function or end." Technically, the term is used for the construction of a model from which a machine, a device, or an instrument can be built to perform certain functions to meet specific needs.

In 1976, a Chinese scholar pointed out that there is an isomorphism between machines and natural regularities (Jin 1986). That means that for every element of any machine, there is a corresponding element of "natural law" that guarantees that the element in the machine will function exactly as the designer of the machine expected. The idea has not received enough attention, but it is helpful when searching for a precise definition of "design." There are four basic elements included in the concept of designing a machine: (1) a purpose or goal, (2) a group of "regularities" as the base, (3) a model or a blueprint as the interim product, and (4) a process of transformation from the model to the machine. On the basis of those four elements, one is able to obtain a functioning machine as the final product. I would call them the four elements of design. Examples supporting that idea can be found in any engineer's textbook, although they may not be stated the same way.

Some of the four elements may not be achievable under specific conditions. Nevertheless, the four elements can serve as criteria to check whether or not a specific design is feasible. The first element indicates that an explicit objective function will be needed by a designer. The third and fourth elements imply that the model must be stable, at least during the time necessary for transformation.

The most important element, which is usually overlooked, is the second one. It means that any design of any machine or device is based on a finite set of natural laws or observed regularities. Those regularities are also understood by constructivist cybernetic ians as "consistencies." Let us name that set, set C. Without set C, no feasible design is possible.

Identifying set C is the very first step toward design. Some designs, however, can be carried out even though one element (sometimes more) of set C is not identified. When that happens, we say a new invention is created, because some new regularity or consistency of nature, or new natural law, is added to human knowledge in the process of designing.

We can now offer a more rigorous definition of design:

> To design is to construct a model based on a set of consistencies observed from the related system; this model possesses an objective

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> function that, when the model is transformed into a machine, will meet the purpose(s) of the designer.

That definition will satisfy most engineers and actually describes design in the engineering sense. There are other meanings of design used by other people. I suggest we give other kinds of designing different names, such as "framing" and "seed forming," which I shall discuss later. In this paper, I will stick strictly to the meaning specified by the above definition when using the word "design."

Implied Consequences of Designing Society

The idea of designing a society in the way one designs an airplane sets up a whole world outlook. The state is viewed as a machine. The party is a fighting machine; the government is a control center. The political leaders are the geniuses, guiders, commanders, steersmen, and finally great general designers, while the ordinary people are screws and gears.

Gears may be big or small and may work in different locations in the machine. Screws should stay wherever the party wants them. According to the official explanation, gears and screws are designed equal (they are not "created equal"), only the duties assigned to them are different. That explains the structure. Sometimes gears and screws get rusty or need to be replaced, cleaned, or repaired. That explains the normal process of maintenance. When something is wrong, it is the controller's exclusive duty to fix it. Ideally, when nothing is wrong, when the machine (society) is running fine, every gear and screw leads a happy life.

How can individuals be made into gears and screws? The answer is by design (i.e., by putting people into educational machines). They include schools, meetings, political studies, study seminars, propaganda, and finally labor camps and jails. Standardization and trivialization of individual minds become the daily practice.

In spite of any possible value judgment about the above ideas, we can use a scientific approach to examine the issue. The development of cybernetics and systems theory indicates that systems created by nature are very different from engineering systems. All systems may be classified into two categories: designable and nondesignable. Engineers are familiar with designables. We are going to explore what the term "nondesignable" means.

Special Characteristics of Human Societies

In order to examine the meaning of a nondesignable system, I shall introduce six specific characteristics of human society and the human

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mind in this section: (1) nontriviality; (2) self-steering, autonomy, and autopoiesis; (3) the gaming phenomenon; (4) Arrow's impossibility theorem; (5) complexity and information limit; and (6) self-organization and evolution. Those characteristics have been examined in the fields of cybernetics and systems theory, except Arrow's theorem, which comes from welfare economics. They are all contradictory to the requirements of design. Moreover, at the end of this section, I shall present a social uncertainty principle, which may be seen as a social version of Heisengberg's uncertainty principle in physics.

Nontriviality

Trivial machines and nontrivial machines are concepts used by von Foerster to draw an important distinction among systems. A trivial machine is characterized by a one-to-one relationship between its input and output (i.e., its stimulus and response). That invariable relationship constructs the machine. It is predictable as well as designable. "All machines we construct and buy are, hopefully, trivial machines. A toaster should toast, a washing machine [should] wash, a car should predictably respond to its driver's operations" (von Foerster 1981). Trivial machines are useful and reliable tools.

A nontrivial machine's output, however, will depend on its input and its history. Here its history means the accumulated impacts of its earlier inputs. An earlier input may change the internal state of such a machine to such an extent that the same input will be responded to differently later. Thus, such a machine is nonpredictable. In other words, the internal state of nontrivial machines is always changing.

Human beings, if they have to be modeled as machines, are nontrivial machines. Human creativity, a vital element of the progress of civilization, grows from that nontriviality. In fact, the phenomenon of nontriviality can be observed in all living organisms. According to von Foerster (1972), a dangerous tendency in civilization is the trivialization of human beings, for example, a dogmatic educational system that gradually ruins students' creativity.

Although the tendency toward trivialization can be observed in all cultures, it is most intense in socialist countries. In order to be used as reliable parts in the whole design, individuals are required to be, and are educated into being, revolutionary screws or gear wheels (i.e., totally predictable trivial machines). The designers may not realize that they are, in fact, using a clockwork universe view of the 19th century. The strong trivialization effect caused by the attempt to design society ruins the creative incentive of individuals. The consequences of such a loss are tremendous and obvious.

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Self-Steering, Autonomy, and Autopoiesis

Self-steering (Aulin 1982) is an important characteristic of the actions of individuals and communities. Research in neurophysiology and cybernetics has revealed that self-steering cannot be formalized into some trivial, objective natural laws. In other words, it has a subjective feature. Thus, self-steering does not fit the requirements of design. The designer has two options: he may either deprive human beings or communities of that property or face the failure of his design.

A mark of the mature development of the human mind and society is autonomy, which can be observed in self-steering and self-authorization (Umpleby 1986). The development of autonomy can be observed as a child grows up or in human history. Designs implemented in socialist countries often deprive individuals and communities of autonomy.

Another model for autonomy is the theory of autopoiesis. Autopoiesis is "the process whereby an organization produces itself. An autopoietic organization is an autonomous and self-maintaining unity that contains component-producing processes. The components, through their interaction, generate recursively the same network of processes that produced them. An autopoietic system is operationally closed and structurally state determined with no apparent inputs and outputs. A cell, an organism, and perhaps a corporation are examples of autopoietic systems" (Varela 1979; also see Maturana 1975, Zeleny 1977).

The Gaming Phenomenon

As a result of our experiences in building a dynamic model of an economic and social system for a province in China in 1985 and our observations of what was happening in the practical operation of China's economic system ("The authority issues a policy; we tackle it with our own strategy" is often heard among business managers), my colleagues and I started to feel that it may not be possible to design a social system in the same sense that one designs an airplane.

In designing an airplane, you put all the proper parts in their proper places according to a blueprint, and the whole assembly flies. But when the elements of the system are gaming with each other, how can one assemble them? What kind of system would it be, and what model or theory can be applied when the system consists of competing elements?

Von Neumann and Morgenstern's (1947) game theory offers some guidance for tackling the gaming phenomenon. The problem with design arising from that phenomenon is that stable consistencies

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cannot be identified while one element's behavior is dependent on another element's behavior. An airplane's components do not game each other for their own purposes, but those in a social system do. Thus, finding set C, specified in the first section of this paper, becomes a problem.

Arrow's Impossibility Theorem

An important breakthrough in welfare economics was Arrow's impossibility theorem in his social choice theory (Arrow 1951). The guiding question of Arrow's social choice theory is whether it is possible to obtain a social choice, or a social welfare function, based on the choices of individuals under certain rational conditions. Such an objective function will be needed in any design as the first of the four elements. The answer, based on the mathematical work of Arrow and others, was no.

Arrow's impossibility theorem states that it is generally impossible to find a set of rules, or a program, from which one can derive a rational social choice function based on the choices made by individuals. In other words, when we try to design a society, it is impossible to find an objective function agreed on by everyone in the society. The designers of socialist societies might have already known that before Arrow. They have used a simple algorithm to solve the problem: "Our design is for all the people. If you do not agree on the goals and the arrangement, then you are not people, hence you are an enemy of the people." Readers from socialist countries are not surprised by such logic.

Complexity and Information Limit

People would agree that social systems are complicated. Any attempt to design a social system must face the issue of complexity. Recent research on complexity has reached the following conclusions: First, complexity is related to the observers of the system via their "notions, perceptions, interests and capabilities"; second, complexity is also related to the system being observed via "the number of elements, the number of relationships among the elements, non-linearity, asymmetry, and non-holonomic constraints" (Flood 1987).

Putting aside the other elements of complexity mentioned above, we discuss only one here, the number of relationships among the elements of the system. W. Ross Ashby (1962) pointed out that in a richly interrelated system containing 1,000 variables, if each variable had only two states, the information needed to totally understand such a system would be 10^{100} bits. That is far beyond Bremermann's

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(1967) information limit, which is 10^{47} bits per gram per second. Ashby (1972) wrote:

> Because of the quantal coarseness of matter, nothing made of it, machine or brain, can process information faster than about 10^{47} bits/g/sec. Take tons of computer and decades of time, and no feasible computation can handle more than about 10^{60} to 10^{70} bits.

And again Ashby (1973) wrote:

> When interaction occurs richly (the case that cybernetics is specially interested in), the quantity of information implied by its complexity is increased exponentially rather than by multiplication.

That fact at least suggests to us that the information processing involved in any rigorous engineering design of a large system, such as a society, is beyond the power of the human brain plus tons of computers. The only way to design such a system is to abandon the attempt to design everything in detail and control aspects of everything. Ashby (1962) contributed a "law of requisite variety," which shed light on new ways of dealing with complex systems. That law states that the control achievable by a given regulatory subsystem over a given system is limited by the variety of the regulator and the channel capacity between the regulator and the system.

Self-Organization and Evolution

Research on self-organization has become one of the hottest frontier fields of system theory in the last 30 years. The basic idea is that organizations come into being by themselves. Order emerges by evolutionary processes, not by design. Those phenomena are widely studied in physics, chemistry, biology, ecology, physiology, psychology, sociology, and cultural studies. Some of the important studies are of dissipative structures, synergetics, and chaos theory (Prigogine 1977, Hanken 1981, Feigenbaum 1980). The general theoretical studies have been carried out in the field of cybernetics (von Foerster 1960, Ashby 1962, Umpleby 1976).

One of the models used to describe the process of self-organization and the mechanism of evolution of such systems is the model of organizational seeds and dual-phase mechanism. An organizational seed is an abstract (mathematical) operator describing a circular cause-and-effect relationship among a set of variables that can lead to spontaneous order. The dual-phase mechanism revealed that the development of a living system relies not only on deterministic causalities but also on random fluctuations (Hu and Sun 1989).

Healthy societies and healthy minds are self-organizing systems. They cannot be designed by outside designers, no matter how good

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the designers are. One may say that there is a way to design the human mind; just block out all outside information, or stop the flow of information. But that will stunt the growth of the mind or severely retard it. A society, even a designed one with a totalitarian government that seems to control everything, still cannot avoid the natural process of self-organization. The only difference is that it will happen in unhealthy ways; one example is the phenomenon of the nomenclatura, which I will discuss later.

Social Uncertainty Principle

Similar to the well-known Heisenberg uncertainty principle in quantum physics, a social uncertainty principle is presented here as the seventh or perhaps the final barrier to the dream of designing a society.

Heisenberg's uncertainty principle tells us that if the behavior of the observer unavoidably influences the state of the system being observed, then the result of the observation is uncertain. That happens when physicists try to observe the behavior of elementary particles. The behavior of the particles may be unavoidably influenced by the observing process, or the choice of observing one aspect of the particles (such as momentum) may make another aspect (such as position) undecidable.

In human society, however, the uncertainty principle occurs on two levels. First, when an observation of a social system is made, there is no way to guarantee that the observation is objective. Soros (1987) called the phenomenon "participatory bias." Constructivists (e.g., von Foerster, von Glasersfeld, and Maturana) have deeply explored that notion. The first level could be called the level of objectivity. Second, when a social system is observed, a model of the system is constructed and predictions about a future state of the system are made and acted on; the system will be changed by those predictions. Prophesies are either self-fulfilling or self-defeating—a feedforward effect.

Feedforward may be explained as a phenomenon symmetrical to feedback. While feedback refers to the mechanism of the effect as a cause, feedforward denotes the mechanism of prediction (of effect) as a cause. Originally, feedforward meant that information about the anticipated results of a process was used to modify the process itself. Soros (1987) calls it the "reflexivity principle" in the field of money markets.

Thus, our social uncertainty principle could be stated as follows:

> The consistency or regularity of a social system obtained via the observer within the system, and the predictability of observations

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> based on such consistency or regularity, is neither objective nor stable.

Many works support that principle. I shall pick just one example. After researching some new developments in sociology, mathematics, neurophysiology, philosophy, phenomenology, and cybernetics, Umpleby (1976) concluded that objectivity is only "shared subjectivity." The effort of obtaining objectivity becomes essentially a matter of achieving agreement. He classified such objectivity as "contested objectivity," comparing it with the earlier "unquestioned objectivity" and "constructed objectivity." Thus, a new understanding of the limits of human knowledge has been offered.

According to Umpleby (1976), three major problems make the ideal of objectivity impossible: (1) Theories of social systems often change the way those systems operate; (2) the scientist offering a theory of a social system is usually an element of the system; and (3) observations must, of necessity, include the characteristics of the observer. We can see that the first problem is the feedforward effect. The other two concern objectivity.

Nondesignability of Living Systems

In this section, I will address the main point of the paper: Because of their specific characteristics, living systems such as societies and human beings are not designable in an engineering sense. The nondesignability of living systems should become a basic principle in human knowledge, if not common sense. That principle should offer some guidance for the reform of socialist countries.

The properties of human societies or social systems, discussed in the last section, are more complicated than the properties of mechanical machines. Human understanding of complex systems has now gone far beyond what was known by Marx and Engels, who proposed their grand theories and started the communist movement over 150 years ago.

Our new understanding of complex systems leads to the conclusion that designing a better society in the same way that one designs an airplane is only an illusion. That illusion has attractions similar to those of the ideals of inventing perpetual motion machines or achieving immortality. Such illusory ideals have been rejected one by one as science has developed.

From the special characteristics discussed earlier (nontriviality, autonomy, the gaming phenomenon, Arrow's impossibility theorem, complexity and information limit, and self-organization), we can see

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that the concept of "design," in the engineering sense, is not going to bring us a better society. The four elements of design are not compatible with the characteristics that are vital properties of human society and the human mind as living systems. By the standards of engineering design, societies and minds are not designable. Even if the design process is carried out properly and all the intended actions are taken, the results, as we shall see in the next section, do not correspond to the original blueprint.

Some communist leaders still believe that Marxism is the utmost achievement of human thought, and the goal of communism is an absolutely correct implementation of "Marxist science." The only way for them to refute this paper academically will be to develop Marxism to a higher level, at which it would be able to offer a better understanding of the phenomena discussed in the second section. They will also have to cure the social diseases, caused by forced design, that we are going to observe in the next section.

Consequences of Forced Design on the Nondesignables

People who believe in Marxism have made tremendous efforts to design whole societies, as well as the minds of the people in those societies. In the beginning, that seemed to work well when the economies of the countries were recovering from the damage of wars. But as time went by, severe consequences emerged in various areas.

In this section, I will identify some major problems that have occurred in socialist countries as a result of trying to design both society and individual minds. Treating society as a machine, and individuals as its parts, has caused the following nine widely observed undesirable phenomena: the phenomenon of strong political control, the phenomena of strong economic control, the hidden nomenclatura, the movement phenomenon, the blindness toward damages, the peacock phenomenon, the dual-personality phenomenon, the childish phenomenon, and alienation. In my opinion, those phenomena are generated by neglecting the special properties I pointed out earlier. They are special social diseases that have infected almost all of the socialist countries.

The Phenomenon of Strong Political Control

The first direct consequence of designing a society was that a strong dictatorship, called the people's democratic dictatorship earlier and the proletarian dictatorship later by Mao, became logical and unavoidable. People who favor such a dictatorship do not like the

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word "totalitarianism," but it expresses the fact that it is the government, not the people, that controls everything.

Some people still believe that strong control is good and will work wonders. But more and more people are beginning to say no to strong control. "The administrative-command system had spread to its superstructure, restricting the development of the democratic potential of socialism and holding back the progress of socialist democracy" (Gorbachev 1987, p. 25). "The progress of socialist democracy" was held back by the following systems for dealing with people, people who are "parts" in a designed machine: residence control, personal political archive monitoring, information control, and thought censorship system.

The oppression of independent thinkers becomes a normal practice in such societies. There are two ways to treat two kinds of intellectuals: The way to treat physical science and engineering professionals is to "make good use of them" and "treat them with good policy." The way to treat those who are able to think on their own is to remold their minds, either by persuasion, called "talking heart," or by force. There are too many cases to be listed here, so I will mention just one. The number of people labeled rightists and forced to be remolded by the Chinese Communist party in 1957 was 550,000 (Dai 1989). Those people lost their youth, their minds, and even their lives just because they expressed their own opinions.

The Phenomenon of Strong Economic Control

Strong central control in the economic arena created the following problems for the designers:

- A rationing system for food allocation, housing, medicine, and education became a heavy burden for the government.
- The resource allocation systems are always making mistakes. the demands are always bigger than the supplies.
- The planned budgets always suffer from the "investment hungry syndrome."
- The "socialist wage rigidity" and "the big rice pot, the iron rice bowl" cause low efficiency.
- There always exists under-the-table gaming behavior between businesses and government.
- The lack of technical innovation provides no incentives or conditions for improving production.

In fact, the pioneer reform economist Kornai from Hungary pointed out that the major reason for the shortage economy in socialist countries is not mistakes in policymaking and decisionmaking but the

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arrangement of the system (Kornai 1980). I would say the misfortunes are not caused by mistakes in some specific design (thus, they cannot be mended by another design) but by the very approach of designing.

Other detailed research done by a group of young Chinese economists also concluded that the control system in socialist countries has caused all the troubles. They propose "a shift in the means of regulation" (Fu, Shi, and Jin 1986). Such a shift would mean the acknowledgement of self-organization and abandonment of strong control.

Nomenclatura: A Hidden Structure

It has been disclosed that there exists a hidden structure within the socialist administrative-command government system, the "nomenclatura." According to Lepin (1991, p. 483):

> The nomenclatura is not a management group, nor a bureaucracy, but only the part of the bureaucracy that occupies key positions in the party, state, or economic apparatus. The nomenclatura is not elected by the masses but is appointed from the top by one person or by a group of people. . . [It] is neither amorphous nor hierarchical but rather it is a corporately organized social group. It consists of representatives of the various classes and social groups, and subsumes differences in viewpoints by arranging its members in various nomenclatura positions. It has clearly fixed values and rules of the game, the breaching of which is punished severely.

The nomenclatura is formed by the process of self-organization, which is a natural social phenomenon. However, because socialist society is supposed to be beautifully designed, things like the nomenclatura have to be hidden from the public. They are a result of self-organizing power struggles that do not fit the designers' blueprint.

Attempts to hide the nomenclatura have generated a strong in-group and out-group split in society. So there are inside documents, inside books and journals, inside decisions. Since the "inside" cannot be exposed to the public, no free press is allowed.

The Movement Phenomenon

Another regular macrophenomenon is that political movements always emerge. The meaning of the word "movement" as used here may be new to Western readers, but people from socialist countries are familiar with the concept. Examples in China include Anti-Three, Anti-Five in 1952; Collectivization and Anti-Gao and Rao in 1953; Eliminating Reactionaries in 1955; Ownership Remold in 1956; Anti-Rightists in 1957; Three Flags in 1958; Anti-Peng's Group in 1959; Anti-Soviet Revisionism in the early 1960s; the Four Clean-

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ups in 1964; and the climax, the Great Proletarian Cultural Revolution from 1966 to 1976.

Officially, those movements are called "mass movements," which sounds like ordinary people initiated them. But those movements, in fact, "moved the masses"; people were manipulated, intimidated, or fooled. Each of those movements was officially announced as a "great victory" for the party and for the people. So far, nobody has been able to investigate exactly how much damage was caused by those movements.

Such movements all have a common purpose: to modify an earlier design or to redesign society. They all have one of two causes. Either they implement a big shift in economic policies or they represent a political struggle within the nomenclatura. The former cause is an effort to change the design; the latter is a fight among designers.

Ordinary people are very tired and afraid of political movements, but they keep happening. Mao used to say that a movement such as the Cultural Revolution "should be repeated every seven or eight years." Mao not only enjoyed instigating movements, he also noted that it would be necessary to modify the design from time to time to keep society going. If the principle of nondesignability is not recognized, harmful movements will continue to occur.

Blindness toward Damages

Because designing is seen as a great achievement, any criticism of or friendly warning about the current system will be interpreted as hostility to the designers who hold power. That way of thinking has caused many tragedies. The result is that errors in and damage to the system accumulate before they are noticed by the power holders. Almost all forecasting research is aimed at describing a beautiful future and an exciting blueprint. Public research on the flaws or potential crises in society is forbidden (He 1988).

Even after the damage is noticed, any reaction is delayed by the ever-expanding bureaucratic system. There is a socialist version of Parkinson's law: Whenever a new need arises in society, a new office will be established in the government; thus, the system expands very rapidly and is dehumanized rapidly. Because extremely limited autonomy is allowed in low-level offices, many decisions have to be handed up to the higher levels. (It has been reported that the first decision about whether a Chinese citizen would be allowed to marry an American had to be made by the paramount leader, Deng, in the early 1980s.)

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The Peacock Phenomenon

Although the peacock phenomenon is found in all kinds of societies, the lack of power balance and the constraint of public opinion extend it greatly in socialist countries. The design-oriented power structure often bases decisions on vainglory, in order to show how successful the design is. Money is often spent on short-term achievements, because they show up quickly, whereas long-term needs are often ignored.

Just to mention one example: Beijing spent over 5 billion renminbi (RMB) on the 1990 Asian Games (Zhang 1990), in spite of the fact that at least 20 million people are living below the poverty line, that the country's economy is in a severe situation, and that there is a very serious shortage of funds for the country's educational system. Those facts render the party's slogan, "to serve the people wholeheartedly," ridiculous.

The Dual-Personality Phenomenon: Split Minds

Living under a problematic design, seeing its dysfunctions, but not being allowed to talk about things as they are will cause an individual's mind to split into two parts. The designed, official part of the mind is active in offices, meetings, political studies, and public speeches. The undesigned, private part of the mind is active at home, among friends, and at unofficial gatherings. Saying one thing and thinking another is a normal practice, a standard by which to measure whether or not a person is mature.

In his New Year's Day address, the new president of Czechoslovakia said, "The worst thing is that we are living in a decayed moral environment. We have become morally ill, because we have become accustomed to saying one thing and thinking another. We have learned not to believe in anything, not to have consideration for one another, and only to look after ourselves" (Havel 1990).

The Childish Phenomenon: Undeveloped Minds

People's minds are not only split, they are also retarded to some extent—like hothouse plants. Because the designers arrange everything, the independent mind has no chance to grow. That infantization of people is caused by the government through its implicit "policies for fooling the people." As a result, people are found to be "timid," to "fear responsibility," and to live "in the grip of obsolete rules and instructions" (Gorbachev 1987, p. 43).

There are always enemies designed to explain to the public all the phenomena that do not fit into the frame of the official world view. The American imperialists, the Soviet revisionists, and the bourgeois

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liberalization are often the scapegoats for the problems of designed societies. Blaming outside elements is another sign of immaturity. It also prevents the development of more realistic concepts, such as cooperation, coexistence, and coevolution.

The Alienation in Socialist Countries

Soviet scientists have offered a generalized view of some of the problems. Using a Marxist term, "alienation," Lapin (1991) points out that in the Soviet social system before perestroika started, the people were alienated from power, the wages were alienated from labor, the peasants were alienated from the land, the production was alienated from needs, the nation was alienated from the citizens, and individuals were alienated from feelings of security.

I would add that the results of socialism were alienated from its original good intention. That understanding has not been reached only by China's young generation through extensive study; it is also seen by many people from the old generation, even though most of them devoted their lives to the seemingly attractive ideal of communism.

Conclusion: Epistemological Change from Dos to Don'ts

Trappl (1986) asked, "Is it possible, at all, to design a political or economic system without considering killing, torture, and oppression?" The answer is clear now.

Almost all of the current reforms in socialist countries are aimed at removing the problems mentioned in the last section, although there are disagreements on what causes those problems. In my view, those phenomena originated from, or at least are related to, an unachievable ideal: designing a better society and, accordingly, designing a new kind of human being. That is the fatal mistake of the current communist ideal. Trying to forcibly design society and human nature causes tremendous problems—both are nondesignable systems.

Nevertheless, nondesignability does not mean nothing can be done to improve our society. Let us go back to our analogy at the beginning of this paper: Although there is no hope of making perpetual motion machines, we have built efficient machines. Although there is no hope of producing medicine for immortality, the human life span has increased and the quality of life has improved. So, although a perfect society is not achievable, there are ways to improve existing societies. New ways of thinking can help us find new directions.

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How do we think about designing? Look back at the definition in the first section. We first set up a group of goals according to our value system; then we look for a set C as a base on which to construct the blueprint, and we carry on from there. The design, if realized, would result in a very large set containing a tremendous number of rules about what we should do, when, where, and how. However, this discussion has shown that that is impossible. So we may look at our value system from another angle. We may pay attention to the negative values, to the things we do not want. If we have to stop building the optimized objective function for the social system, we may concentrate on preventing things that our value system rejects.

By setting up a minimum group of constraints and letting human creativity work freely, we can create a better society without having to design it in detail. That is not a new idea, it is the idea of law, the idea of a constitution. Real constitutional government is a possible alternative to the dream of a perfectly designed society. "To design" is replaced by "to manage," "to regulate," and "to participate." Regulations come into play only when errors occur. In that way, we offer space for variety, flexibility, and development in our social system.

That way of thinking may be called limited design by some system scientists. The idea is to apply the principle of self-organization. I think it would be confusing to continue to use the word "design" and, therefore, suggest we choose other terms such as "framing" and "seed forming." Framing sets the constraints that represent our negative value system, such as the establishment of a legal system. Seed forming introduces mechanisms that work automatically, such as the market mechanism. New light is shed on a saying of Confucius: "People should be allowed to be free by themselves; they should not be told to behave."

Ashby's law of requisite variety may be another helpful guide in building a small, efficient government. In other words, the degree to which an organization can be regulated is limited by the variety of the organization's regulatory systems. That implies that distributed power or pluralization may achieve better management (see Ashby 1981).

Many scholars referred to in this paper have been looking at complex systems in different ways. Compared with the traditional methods (usually Newtonian), the new approaches open new doors to understanding and managing complex systems.

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The First and Second Reich: The Taming of an Industrial-Policy Advocate

Richard B. McKenzie

Introduction

Retired Harvard University economist John Kenneth Galbraith developed an illustrious career arguing that the public sector should be expanded and that the private sector—especially dominant large firms that make up the "new industrial state"—should be more tightly controlled by government (Galbraith 1967). With wit and a writing style that remains the envy of novelists, Galbraith has argued for four decades that an "affluent [capitalistic] society" would be beset with problems of a dominant business sector and upper income class, an anemic public infrastructure, and an impoverished underclass unless a caring and enlightened electorate used the power of their votes to do what was right (Galbraith 1958). Doing what was right generally meant making government a "countervailing power," or an offsetting social force, to the large and growing multinational corporations (Galbraith 1952). It meant fine tuning the economy with macroeconomic fiscal and monetary controls, even national planning that would supplant corporate planning; increasing tax rates on the rich; and expanding government expenditures on a variety of social programs.

By the early 1970s, much of Galbraith's social agenda had been tried.[1] However, by the late 1970s and early 1980s, much of the

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[1]Between the publication of Galbraith's theory of countervailing power in 1952 and his retirement from Harvard in 1978, total government outlays doubled in constant dollar terms and expanded as a percentage of gross national product (GNP) from 27 to 31 percent. Government's regulatory agencies' authority had expanded far more than expenditures. From the mid-1960s through the late 1970s, 20 major federal (social,

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public appeared to have become disillusioned with the Galbraithian social agenda. After all, decades of government's fine tuning had left the country deep in "stagflation" and mired in debt. Poverty had not been relieved by a vast increase in social programs, and Congress continued to waste a lot of money catering not so much to broad and laudable national goals but to the narrow special interests of the politically powerful (who rarely included representatives of the poor).

In the early 1980s, it looked as though Galbraith's policy mantle had been dropped with no apparent heir to pick it up. Nevertheless, his mantle was retrieved and retained at Harvard. Robert B. Reich, on the faculty of Harvard's John F. Kennedy School of Government, is a student of Galbraith, either by way of Galbraith's classes or just his writings. Whatever the connection, Reich draws directly from Galbraith's work on industrial organization and shares many of the social, if not socialist, sympathies and political, or Democratic, leanings of his mentor: higher tax rates on what he calls the "fortunate fifth" of Americans, more government spending on social welfare programs for the disadvantaged and the working classes, and greater government controls on industry. He also shares his mentor's literary flare and his penchant for striking a responsive chord with a broad segment of the media and the public policy establishment in Washington.

However, in contrast to the consistency of Galbraith, Reich has articulated, within less than a decade, two, largely distinct, philosophical foundations for relieving the problems of what is perceived to be the not-so-fortunate four-fifths of the country's population. The purpose of this study is to compare and contrast Reich's two world views, the first articulated in the early 1980s in *The Next American Frontier* (1983) and the second in *The Work of Nations* (1991). We will find that the dire predictions Reich makes in the first book never materialized, even though his reform agenda was never adopted. That is just as well, for in the latter book Reich repudiates much of the industry-based government control and subsidy policies advocated with vigor in the former. We will also find that his remaining, and somewhat revised but still expansive, social agenda forged with

environmental, and economic) regulatory agencies were created, raising the total count of major agencies by two-thirds (Weidenbaum 1981, p. 54). The total administrative costs of all federal regulatory agencies expanded in constant dollar terms by 142 percent in one decade alone, the 1970s, for an average real growth of over 14 percent a year. The costs businesses incurred from complying with the added regulations escalated even faster than the cost of administering the programs (Warren and Chilton 1990, p. 4).

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equal vigor in *The Work of Nations* is no longer consistent with his analytical framework. Nevertheless, Reich's early political predisposition, heavily weighted toward making government the nursemaid of American industries, has been tamed by time and the global technological trends he identifies. He has, in effect, shifted from being one of the nation's leading exponents of industrial policies to one of the leading exponents of freer markets, except in the provision of educational services and the rebuilding of the country's infrastructure. While hardly a conservative, he is no longer the Galbraithian liberal he once was.

Reich's Next American Frontier

Robert Reich literally burst onto the national public policy stage with the publication of *The Next American Frontier* (1983). In that book, Reich set himself up as a leading academic guru and foilsman for what, in the 1980s, became known as the industrial policy movement. That movement, and Reich's book, was grounded in the proposition that America was, as it had been for more than a decade, in relentless economic decline. Indeed, Reich starts his book with an ominous assessment: "Since the 1960s America's economy has been slowly unraveling. The economic decline has been marked by growing unemployment, mounting business failures, and falling productivity" (Reich 1983, p. 3). He was not concerned simply with the recent problems that emerged with the recession of 1980–81 or with a narrow sector of industry or a particular income class, but with the fate of the country—the full breadth of the economy—during the rest of the century, if not beyond. His goal was to revive the Galbraithian policy tradition to provide the intellectual inspiration for an economic rebirth of the American economy by a fundamental redirection of the way economic policies are formulated. A centerpiece of his economic strategy was the supplantation of government social agencies by private firms, which would be more efficient, effective, and pervasive conduits for government subsidies than government agencies could ever hope to be.

Reich argued that the country's GNP per capita had, by the early 1980s, fallen below levels achieved in other countries, and that the country's life expectancy was lower and its unemployment and infant mortality rates higher than those of most other advanced industrial economies. He claimed that long-term (15-year) trends would "worsen unless we act deliberately and strategically to speed the movement of capital and labor into higher-valued production" (1983, p. 238). America's next frontier would be, Reich argued, one of

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adaptation, of acknowledging changes in the world economy, reorganizing the way Americans do business, and adopting a role for government that would stand in sharp contrast to the free-market agenda of the Reagan administration.

Reich (1983, p. 21) noted that the process of adaptation would be made all the more difficult if the economic decline were allowed to continue "because then change threatens the economic security of people who are desperately trying to hold onto what they have." Nevertheless, any failure to adapt along the lines recommended would "rend the social fabric irreparably."

The seeds of America's decline that, supposedly, became patently evident in the late 1970s and early 1980s, according to Reich, had been sown a long time before, perhaps starting as early as 1870. The American economy began its trek toward being an industrial power during the last third of the 19th century because it had been blessed with an abundance of natural resources and a reasonably well-skilled labor force that, through immigration, had been extensively imported from abroad. Somewhat fortuitously, in Reich's theory of economic development, between 1870 and 1920, a major new invention (such as the typewriter and the electric light bulb) "made its appearance in America, on average, every fifteen months," fueling further industrial expansion (1983, p. 26). Being as large and unified as it was, the country was well suited for the development of large-scale industrial enterprises that relied on long runs of standardized products.

Problems emerged along the way, but most were partially rectified, de facto or de jure, by government action or acquiescence. "Ruinous price competition" set in. The vast company labor forces required by the technology of high-volume production "strained the average company's ability to manage, resulting in wasted effort and labor unrest" (1983, p. 32). The urbanization of workers also taxed the "government's limited capacity to ensure a minimum level of public health and safety" (1983, p. 32). In general, American firms had grown lethargic and uncompetitive, mainly because they had been overly protected from market forces by international trade barriers or by industrial collusion.

Pervasive price competition in the late 19th century was extensively solved by informal trade associations bent on collusion and by formal trusts and cartels among major market competitors. "Individual firms did not need to worry that their competitors might suddenly introduce a new innovation that would render current technologies obsolete since they already knew what their rivals were planning," a process that, Reich (1983, pp. 89–90) reasoned, ensured continued reduction in per unit costs . As a consequence, sometime during the

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first half of the 20th century, "market competition ceased to be the main force behind the evolution of American industry; nor were there many businessmen who could contemplate an unmanaged economy with anything but anxiety" (1983, p. 56).

In the 1920s, the birth of "management science," which fostered simplification of workplace tasks, predetermined rules for decision-making, and relied on an expanded information system internal to firms, enabled large firms to become larger and achieve further cost reductions with economies of scale. Those firms' potential overcapacity problems were remedied for a time by managing demand through advertising and by the development of conglomerates, which added stability through the addition of "new products and markets to compensate for the declining ones" (Reich 1983, p. 84).

The rise of unions across industries further reduced price competition by reducing wage competition. According to Reich (1983, p. 92):

> With labor increasingly organized along industry lines, a similar structure on the management side facilitated collective bargaining. Industry-wide coordination of investment and production also made firms more generous with wage increases because—if all companies granted them—wage concessions would not harm any one firm's competitive position and could safely be passed on to purchasers in the form of higher prices.

Franklin Roosevelt's New Deal sought to relieve many of the growing social problems that firms encountered with the growth of cities and industrial work forces. By the 1960s, the burning social issue, Reich maintained (as had Galbraith 16 years earlier), was no longer whether there would be planning (or the explicit control and direction of market forces), but who would do the planning—private firms or the government.[2] Both Galbraith and Reich made the case for their favored forms of government-directed national planning by maintaining, in so many words, that planning would be nothing new, only the motivation would be elevated and the results improved. "A

[2]Reich (1983, p. 232) writes, "America's free market has been supplanted by interlocking networks of subsidiaries, conglomerate headquarters, and financial institutions, through which industrial assets are rearranged and managers are recirculated, but from which new products and processes rarely emerge." Galbraith (1967, p. 6) had, in *The New Industrial State*, already declared that

> we have an economic system which, whatever its formal ideological billing, is to a substantial part a planned economy. The initiative in deciding what is to be produced comes not from the sovereign consumer who, through the market, issues the instructions that bend the productive mechanism to his ultimate will. Rather it comes from the great producing organization which reaches forward to control the markets that it is presumed to serve and, beyond, to bend the customer to its needs.

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social organization premised on equity, security, and participation will generate greater productivity than one premised on greed and fear" (Reich 1983, p. 20).

In spite of government growth in a variety of areas, the American economy began to come unraveled around 1970, according to Reich, not because of the then-growing government deficits or the expansion of environmental and social regulation or the lack of investment in physical assets and research, as many others had suggested, but because of changes in the world economy. Key American industries had become uncompetitive at the same time the world economy had become more competitive. As a consequence, the U.S. economy had stagnated and then had begun its inexorable decline.

Why the decline? Reich argued that the American polity was, regrettably, still wedded to the outmoded free-market ideology; the polity was unable or unwilling to recognize the social benefits of explicit government intrusion in the economy. The result was a patchwork of business policies that were not very effective. Furthermore, American industries remained tied to old ways of doing business, most notably mass production of standardized products that, because of the advent of international trade, could be produced more cheaply with low-wage labor elsewhere in the world. That practice was causing America's manufacturing base to erode precipitously (Reich 1983, p. 127).

America's competitive position was also hampered because its businesspeople had become enraptured with "paper entrepreneurialism" (dubbed the "bastard child of scientific management") that involved the largely unproductive "manipulation of rules and numbers that in principle represent real assets and products but in fact generate profits primarily by the cleverness with which they are employed" (Reich 1983, p. 141). Never mind that changes in ownership might improve the efficiency with which the business resources are used. Never mind that the buying and selling of businesses might have been the result of a new competitiveness in the country, brought on by the expanding global economy. Never mind that in order for sales to go through, entrepreneurs and firms must expect a higher income flow from their assets than did the previous owners.

Reich was confident that shifts in the ownership of businesses and their assets through mergers and takeovers had no benefits. In Reich's words (1983, p. 145), paper entrepreneurs "do not enlarge the economic pie; they merely reassign the slices," increasing the cost of American products. Similarly, American businesses had become, by the late 1960s, overly enthralled with the building of conglomerates that "served no useful purpose" (1983, p. 151) and

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had sought to cover over their growing ineptitude by relying more and more on public relations activities that were no more productive than paper entrepreneurialism (1983, p. 154). Those bold claims were made with little or no supporting evidence and certainly with no attempt to counter opposing arguments concerning the positive economic and social benefits of mergers and takeovers.[3]

America's competitive problems were exacerbated by the Europeans and Japanese, especially, who had been far more effective in coordinating their structural adjustments via formal industrial policies. "Instead of the *ad hoc* scatter of separate industrial superstructures that developed in the United States, the tendency in continental Europe and Japan was to unify and coordinate economic policymaking across industries," that policy rendered their decisions more flexible than those of U.S. regulatory agencies and their government work far more attractive to talented university graduates than was the case in the United States (Reich 1983, p. 110).

The Industrial Policy Agenda

In *The Next American Frontier*, Reich's reform agenda amounted to a plea for the American polity to change its political inclinations and for American industries to change their ways, to stop seeking protection from competition, to shuck their reliance on standardized production processes, and to become more flexible in their structural arrangements. More important, he advocated a far-reaching industrial policy agenda that would make businesses and their workers the conduits for strategic implementation of government largess, protection, and tax incentives.

In general, his program was premised on the presumption that "America and in a similar sense Britain are victims of their own past success" in mass production (Reich 1983, p. 231). He maintained on more than one occasion that

> the only way industrialized nations can increase their citizens' standards of living in the future is to concentrate on the high-value niches within those industries [for example, textiles, automobiles, rubber, and chemicals that were then, supposedly, in rapid decline] and to seize and keep world leadership in new industries based on advanced and emerging technologies" [Reich 1983, p. 231].

The U.S. government, argued Reich, should follow Japan's lead with its Ministry of International Trade and Industry (MITI). According to Reich, the United States should be given the authority to

[3]Many of the benefits of so-called paper entrepreneurship are covered in Weidenbaum and Chilton (1988).

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orchestrate the much-needed adjustment in the country's industrial structure:

> America must have the institutional capacity to marshal precise information about the needs of the declining industries and their dependents and to negotiate adjustment agreements that preserve the interests of the emerging industries. In both these aspects of industrial policymaking—acquiring strategic business information and negotiating adjustment agreements—the superstructures of management [in government] are sorely lacking [Reich 1983, p. 195].

While Reich complains that critics have far too glibly caricatured his industrial policy agenda as one of "picking [industrial] winners and losers," he boldly claims that the key to MITI's success lies in

> the explicit subsidies given to firms that agree to scrap excess capacity and in the firms' use of these subsidies to retrain and relocate their workers for more profitable endeavors. The subsidies for scrapping thereby accomplish two related objectives: They induce the least competitive firms to exit from the industry, thereby improving the profitability of more competitive firms; and they provide workers with adjustment assistance that is geared to cushioning and accelerating industrial change [Reich 1983, p. 199].

Reich (1983, p. 204) proposed the next American frontier could be conquered only by a dramatic increase in government expenditures on worker training, relocation allowances, unemployment compensation, workers' compensation, and health insurance—all of which are designed to eliminate dead-end jobs and to ease "the transition of its [America's] work force into skill-intensive production." Nevertheless, the novelty of his social agenda lay in the strictly industrial policies, ones designed to aid and abet an industrial transformation by manipulating the behavior of firms. In 1983, he advocated subsidies for firms locating in areas of high unemployment, tax incentives that would encourage firms to provide worker training (especially for older workers), tax penalties that would discourage layoffs, government procurements from businesses that would be undertaken explicitly to induce structural readjustments across industries, and selective international trade restrictions that would also encourage structural change (1983, pp. 239–47). He foresaw the development of a brand of industrial democracy in which workers would participate not only in training decisions but also in decisions about physical investment, reinvestment, disinvestment, and plant closings.

More generally, he proposed that firms become the social agents of the state. The state need not become larger, Reich (1983, p. 248)

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assures his readers on occasion (although it is difficult to see how it would not):

> Public funds now spent directly on these services [health care, Social Security, day care, disability, unemployment, and relocation] will instead be made available to businesses, according to the number of people they employ and the number of chronically unemployed they hire. Government bureaucracies that now administer these programs to individuals will be supplanted, to a large extent, by companies that administer them to their employees. . . . In this way, firms will become the agents of their employees, bargaining on behalf of their workers for different packages of government-supported social services. . . . Business enterprise, therefore, will largely replace geographic jurisdictions as conduits of government support for economic and human development. Companies, rather than state and local governments, will be the agents and intermediaries through which such assistance is provided.

While he does not always say so explicitly, it is quite clear that Reich was talking about the next American frontier being forged by American firms aided and abetted by the American government.

He also supported the creation of regional economic development—banks whose capital allocation decisions would be made by what came to be known as "tripartite councils" composed of representatives from management, labor, and government—and the creation of a "public board," located in the White House's Office of Management and Budget. Together, they would monitor all of the government's industrial efforts and "each year recommend to Congress and to the president what changes should be made in programs that may be retarding national economic development" (1983, p. 245). Still, Reich claimed that his agenda would not make government more "extensive," only "more open, more explicit, and more strategic" (1983, p. 14).

The Work of Nations

A series of books soon followed the tone set by *The Next American Frontier*. They all argued that the country was on a slippery economic slope and that the only possible remedy was a new, strategic, broad-based industrial policy, funded by greater taxes, mainly higher marginal tax rates on the wealthy.

Daniel Sharp (1988, p. 5), president of the American Assembly, stated flatly, "America can't compete." Harvard University economist Benjamin Friedman (1988, p. 300) joined the chorus with the lament, "The saddest outcome of all would be for America's decline to go on, but to go on so gradually that by the time the members

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of the next generation are old enough to begin asking who was responsible for their diminished circumstances, they will not even know what they have lost." And Yale University historian Paul Kennedy (1987, p. 534), the most prominent and widely read of the decline theorists, attested that the main "task facing American statesmen over the next decades, therefore, is to recognize that broad trends [of lost economic and political hegemony] are under way [for the United States], and that there is a need to 'manage' affairs so that the *relative* erosion of the United States' position takes place slowly and smoothly."

Nevertheless, the ensuing years were not kind to Reich's and others' predictions of continued economic decay. The Reagan administration was openly hostile to practically all industrial policy agendas, thwarting the passage of every serious proposal at nearly every turn. Instead of raising tax rates, Reagan lowered them, even for the rich. Government expenditures continued to rise in real dollar terms but stagnated as a percentage of GNP. Government regulatory agencies also had budget increases in constant dollar terms, but many saw their budgets contract as a fraction of the national economy and their labor forces fall in absolute numbers or, at least, relative to the expanding civilian labor force. Some rechanneling of federal government expenditures occurred, but it was mainly from Reich's favored social programs to defense outlays and interest payments on the mounting federal debt.[4]

Nevertheless, the country did not continue along the path of decline, or "deindustrialization," that was presumably afoot in the early 1980s. Indeed, real GNP was 27 percent higher at the end of the decade than it was at the beginning, real per capita disposable income grew by 17 percent throughout the 1980s, and total employment grew by over 18 million, or 18 percent, during the decade. At its peak in 1990, before the advent of the current recession, the industrial production index stood 24 percent above its 1980 level. Even manufacturing output, which was supposed to be evaporating with import competition, continued to rise in real terms and to remain at more or less the same percentage of GNP that it had been during the four previous decades, in spite of the fact that the number of U.S. manufacturing employees fell by about 2 million. (At the same time, employment in the foreign affiliates of U.S. manufacturing firms more than offset the domestic decline in employment.)

[4]The changes in the role of the U.S. government in the economy during the 1980s are charted in McKenzie and Lee (1991, chap. 8).

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Contrary to what might have been inferred from Reich's and others' assessments of what was happening and would continue to happen, U.S. production did not even decline relative to the output of the rest of the world. Total production in the United held its own, relatively speaking, in the world economy during the early 1980s. It rose slightly, relatively speaking, in the late 1980s (despite the obvious overstatement of the level and growth of production in the Soviet Union and other, now former, communist countries in Eastern Europe).[5]

Such facts notwithstanding, in 1991, Reich returned to print with *The Work of Nations*, in which he makes a major effort to reinterpret the recent economic history of the United States and the world and to forewarn of pending economic calamity if public policy is not reconstituted. By 1991, however, he had shucked, and for good reason, much of the explicit firm-centered industrial policy agenda that he had advertised as crucial. His analytical framework had changed, mainly because his vision of world conditions had changed radically since the publication of *The Next American Frontier*.

In *The Work of Nations*, Reich (1991, p. 4) starts by appearing to assume the role of the detached observer of political commentators, noting the "numbing regularity" with which other political partisans, pessimists and optimists alike, appeal to economic data to make the case for their favored policies, never admitting that he may have been one of the partisan commentators. "The optimists point ever upward: Look at the number of new jobs! Marvel at all the small entrepreneurial firms! . . . The economy is booming as never before. . . . The pessimists point downward: Bemoan the loss of manufacturing. Bewail the trade deficit. . . . The economy is collapsing around us."

Who is right? Without saying so, Reich is forced to concede that the metaphor of the sinking economic ship of state that he exploited (in various forms) with great care in his earlier book no longer applies. The problem of picturing national economies as a "worldwide regatta whose prize is economic preeminence," which he had in no small way fostered, is, bluntly put, all wrong (1991, p. 5). Granted, the picture of the ship of state may have been appropriate, say, when Galbraith wrote *The New Industrial State* or even as late as 1983 when Reich wrote *The Next American Frontier*, but no longer. According to Reich, the world and its national economies have become fractured and, at the same time, integrated.

[5]The details of those arguments are covered in McKenzie (1988).

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Admittedly, Reich seeks to make his new work appear to be an extension of *The Next American Frontier* by recasting much of the earlier historical analysis, articulated in the best of Galbraithian traditions, without explicitly conceding that his policy conclusions were misdirected. Rather, he simply repeats his earlier claim that, at one time, America's industrial might expanded because of the growing dominance of America's large corporations that became even larger because of their successful efforts to suppress competition through collusion, mergers, and consolidation (although he offers only a rudimentary and confused theory of how collusion and the monopolization of markets, which normally lead to higher prices, actually lead to lower prices).[6] At that time, "the well-being of citizens was linked to the success of the national economy" (1991, p. 34), which in turn was tied inextricably to the success of the dominant corporations. In strict accord with Galbraith's much earlier work, Reich notes that 500 major corporations represented the core of the American economy, mainly because they produced half of the country's output and owned the vast majority of the country's industrial assets. Those 500 "were the champions of the national economy; their successes were its success. They *were* the American economy" (1991, p. 47; emphasis in the original).

However, the world has changed, Reich correctly argues. Production has become globalized and integrated. The image of the economic fates of American citizens rising and falling together, as if in a single boat, is no longer apt, mainly because the boat is no longer American made, or at least not totally so. Indeed, " 'American' corporations and 'American' industries are ceasing to exist in any form that can be meaningfully distinguished from the rest of the global economy" (1991, p. 77). The question, "Who is us?" can no longer be answered simply.

Technology has made capital, especially, far more mobile than it once was. "Money, technology, information, and goods are flowing across national borders with unprecedented rapidity and ease" (Reich 1991, p. 6). The result is that General Motors, General Electric, IBM, and a host of other American-grown companies produce

[6]Reich (1991, p. 67) writes, "[T]he core American corporation would plan and implement the production of a large volume of goods. The large volume of goods would create significant economies of scale, thus reducing the cost of producing each unit. By coordinating with other core corporations, prices could be set high enough to ensure substantial revenues," which would be shared with managers and union members alike. Reich does not say where the core corporations get the power in the first place to plan and implement long production runs. Presumably, they must engage in price and nonprice competition to take over a major share of the market, which hardly represents the type of power normally associated with monopolies or cartels.

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products that are only part American. At the same time, the German firm Seimans produces products that are only part German; they are also part American.

Those simple observations obviously had a profound impact on Reich, for without ever acknowledging the changes in his own thinking, he writes, in *The Work of Nations*, that "few ideas are more dangerous than good solutions to the wrong problems." He then adds, again as if he had never been a party to the earlier industrial policy debate, "Politicians and pundits talk loosely of 'restoring' or 'restarting' American business. . . . Others offer plans for regaining America's competitive edge and revitalizing the American economy. . . . [A]ll suffer from vestigial thinking about exactly what it is that must be restored . . . or revitalized" (1991, p. 243).

Then, repudiating much of his earlier industrial policy agenda, which made American-grown corporations the policy pivots, Reich concludes that "there is no longer any reason for the United States—or for any other nation—to protect, subsidize, or otherwise support its corporations above all others, as some have argued. . . . Neither the profitability of a nation's corporations nor the successes of its investors necessarily improve the standard of living of most of the nation's citizens" (1991, p. 8). If the country tries to subsidize companies, the policy benefits will not necessarily be retained in the United States; the government largess will simply be allocated, as are all other company funds, to the most profitable venue in the world, which may be the United States but may also be Sri Lanka or New Zealand.

Instead of government benefits being routed to "American" corporations, writes Reich, they should be routed to the heart and soul of the economy, and society, the immobile infrastructure, which includes the education, transportation, communication, and utility systems. The benefits should also be routed to the equally immobile American people, specifically American workers, not all of whom are in the same economic boat (1991, p. 173). In fact, Reich (1991, pp. 174–80) distinguishes three boatloads of people, the "routine production workers" (those engaged in repetitive tasks in high-volume production processes), the "in-person service" providers (those working directly with other people mostly in repetitive tasks), and the "symbolic analysts" (those involved in problem identification and solving and in "strategic brokering" of resources). From an array of data on changes in income distribution, Reich deduces that his critics were right: "America" is not in long-term decline. On the other hand, he concludes that, while the aggregate income and production figures show continued progress, the income-distribution statistics

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reveal regression for the four-fifths of the population who are, for the most part, from the ranks of the routine production workers and the in-service providers and who must compete vigorously for work with low-paid labor in underdeveloped countries. Only the top fortunate fifth of all income earners—who in the aggregate receive more than half of the nation's income and who are mostly university-educated symbolic analysts—have prospered over the past two decades, mainly by selling their high-demand services to the highest bidder in the global marketplace and by being the principal beneficiaries of the Reagan tax cuts and other policy shifts.

A return to economic prosperity for most Americans means a substantial increase in government expenditures on formal education, on-the-job training, and basic transportation and communication systems on which businesses of all national origins thrive. For the wealth of a nation is no longer businesses that are now footloose on a global scale. Rather, "the skills of a nation's work force and the quality of its infrastructure are what make it unique, and uniquely attractive, in the world economy. Investments in these relatively immobile factors of worldwide production are what chiefly distinguish one nation from another; money, by contrast, moves easily around the world" (Reich 1991, p. 264).

The Problems Inherent in the New Vision

My purpose here is not to critique in detail Reich's newfound policy conclusions drawn from income-distribution statistics, although his statistics and conclusions are worthy of challenge. I will simply note that his conclusions should be studied with healthy skepticism. The relayed facts on income distribution may be no better interpreted today than were the facts on industrial organization and the usefulness of industrial policies in the early 1980s. I will simply note that Reich (1991) is able to conclude that four-fifths of Americans have not been progressing economically. He arrives at that conclusion partly because he ignores the growth in nonwage benefits, uses the flawed consumer price index for computing changes in real income, often fails to adjust for changes in the characteristics of the labor forces and the jobs that are filled, focuses on the average incomes of the five quintiles of income distribution, and at times juxtaposes discussions of reductions in the shares of the nation's income going to the lower quintiles with discussions of decreases in their absolute income levels. For example, he points out that the average wages and incomes (not including fringe benefits) of a sizable segment of the population (mainly in-service providers who

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account for about 30 percent of the labor force) did not rise during the 1980s and that the average income of another sizable segment (mainly routine production workers who make up about a quarter of the labor force) actually fell. He then concludes that four-fifths of the population (the entire labor force minus the 20 percent who are symbolic analysts) are no better off than they were a decade or more earlier.

However, the appeals for changes in income shares often hide real income increases, and the stagnant or falling averages employed ignore the number of Americans in the lower four-fifths whose economic lots actually improved during the 1980s as much, if not more, than the economic lots of Americans in the fortunate fifth. Furthermore, the fact that the average income of the fortunate fifth went up in the 1980s does not mean that some of its members did not regress. Very likely, some members of the fortunate fifth experienced increases, while others experienced declines. Indeed, the history of American income distribution has been one of considerable shuffle among the quintiles of the income spectrum. For example, a study of changes in income distribution during the 1970s found that 50 percent of the people in both the top and the bottom quintiles in 1978 had changed places in the income distribution since 1972.[7]

Such issues must await more study. My purpose here is to recognize the partial but striking convergence of economic and political thinking that the advent of the global economy has imposed on public policy commentaries. Reich, in *The Work of Nations*, and Dwight Lee and I, in *Quicksilver Capital: How the Rapid Movement of Wealth Has Changed the World*, both of which were released within two months of one another, begin with many of the same premises:

1. Developments in technology have drastically reduced the cost of international transportation and communications and have greatly increased capital mobility.
2. National economies have become integrated and interdependent, so much so that "nation " and "national economies" have lost their meaning.
3. Business has become global because competition has forced firms to seek low-cost production venues without regard to exact location.
4. Businesses and people must do what is necessary in the way of upgrading their education and product quality and in the way

[7]As reported in Browning (1989).

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of minimizing costs to meet not just national standards but world standards.[8]

5. Industry-based industrial policies, whether in the form of import protection or subsidies, will not, in the context of the global economy, improve the living standards of people.
6. Financial and physical capital, in general, is more mobile internationally than human capital. However, some human capital, including the skills of symbolic analysts, is just as mobile internationally, if not more so, than financial and physical capital.
7. The economic fates of Americans are no longer moving together. As they diverge, "the top may be losing the long-held sense of connectedness with the bottom. . . . Ironically, as the rest of the nation grows more economically dependent than ever on the fortunate fifth, the fortunate fifth is becoming less and less dependent on them" (Reich 1991, p. 250).
8. Most Americans (and Germans and Italians) already bear a heavy tax and "cannot afford to shoulder the added burden of higher levels of public spending [implied by Reich's social agenda]. It would have to be borne instead by the one group of Americans whose earnings have been increasing—our symbolic analysts" (Reich 1991, p. 250).

Where we part company is on the policy conclusions. Reich says, in so many ways, that the cuts in federal taxes and expenditures orchestrated by the Reagan administration are the source of many of our current national maladies and that the social policies of the 1980s must be reversed. Government social expenditures on everything from education to care for the homeless must be treated as outlays on the national infrastructure and must be greatly expanded. To finance the greater social expenditures, the marginal tax rates paid by people with "princely incomes" must be drastically raised.

In contrast, Lee and I argue that the technological and capital mobility conditions that Reich identifies were the cause of the policy course of lower tax rates, deregulation, and privatization observed during the 1980s in the United States and in most other major countries around the world. Capital mobility had made the United States and other countries competitors for the world's capital base, and they

[8]Lee and I could not agree more with Reich (Reich 1991, p. 265) when he writes that higher skills and higher compensation go hand in hand and that "without adequate skills and infrastructure, however, the relationship is likely to be reversed—a vicious circle in which global investment can be lured only by relatively low wages and low taxes. These enticements in turn make it more difficult for the nation to finance adequate education and infrastructure in the future."

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had to start competing for the capital base by lowering taxes and making production in their respective countries more cost effective. We suggest that governments' fiscal and regulatory hands are tied as never before for the very reason Reich notes in passing but then virtually dismisses as irrelevant to the development of policy: The people with symbolic-analytical skills and princely incomes will be the ones who will be forced to bear the burden of the expanded government programs (Reich 1991, p. 250), but they will also represent some of the most mobile of all capital (in fact, they have been using their newfound mobility to secede from the rest of the nation) (Reich 1991, p. 251).

Conclusion

In the early and mid-1980s, public policy debates were conducted extensively along ideological, normative, and empirical lines. Policy partisans from the left and the right articulated and defended well-honed sets of principles. Partisans on the right paid their respect to the market principles laid down by Adam Smith and Milton Friedman, while partisans from the left appealed to the collectivist principles of Galbraith, if not Karl Marx. Empirical claims regarding the fact and extent of deindustrialization were made, defended, and challenged. Everyone was ultimately interested in specifying, in the name of fairness, equity, or efficiency, what governments should do. Robert Reich and I know that debate all too well. We were partisans in it, although almost always from polar analytical and political positions.

The character of the debate in the 1990s has changed for all of us. We have noted the considerable agreement on the facts of the global economy. In that regard, our views have converged. Accordingly, the debate among partisans has become less grounded in ideological and empirical concerns. At the same time, some divergence remains, but the debate has been solidly joined on grounds that will ultimately be resolved not by partisan writings but by events in the world economy. The current debate appears to be over not what we all would like or what ideology would prescribe but rather over what governments can do and will be able to do for people, given the rapidly escalating mobility of capital and, for that matter, people. That escalating mobility may very well prevent governments from enacting the type of expansive aid for the not-so-fortunate four-fifths of the income distribution that Reich would have the fortunate fifth finance. I suspect that when Robert Reich goes to print with his next best seller, he too will have seen this basic point: Transnational

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economic forces are imposing tight controls on the political affairs, even the democratic affairs, of people whose allegiances to countries are being relentlessly dissipated.

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The Federal Reserve Chairman as Hero: Our Defense against Monetary Excesses?

Thomas Havrilesky

Introduction

Over the past 55 years, the politicization of monetary policy has required the evisceration of formal institutional constraints on monetary excesses, namely the elimination of the gold reserve ratio, a reduction in the (decentralized) power of the Federal Reserve banks, and a diminution in the strength of private-sector representation[1] within the Federal Reserve system.

Correspondingly, over the same time span, power within the system has shifted to the Federal Reserve Board and particularly to its chairman. The authority to contain monetary excesses that typically stem from political pressure on our central bank now resides largely in the strength of the anti-inflationary persona of the chairman. Thus, our society's traditional defenses against inflation have been transferred from formal institutions to the will power of a single person, the Federal Reserve chairman.

In exchange for greater influence over monetary policy, politicians have had to pay more and more lip service to Federal Reserve autonomy. Politicians' apparent bequeathal of greater autonomy to the central bank is not entirely self-sacrificing. It appears to relieve the politicians of responsibility for periodic economic misfortunes, many of which are traceable to political manipulation of monetary policy (Kane 1982, 1990). As a consequence of that realignment, the

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[1]Federal Open Market Committee (FOMC) members with career experience at Federal Reserve banks and in the private sector have generally been considered to have a more conservative attitude toward montary policy. Their voting behavior at the FOMC over the past 40 years seems to support that view (Havrilesky and Schweitzer 1990).

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anti-inflationary posture of the Federal Reserve chairman has taken on heroic proportions. It has become an absolute political necessity that the chairman appear to be very conservative. Nevertheless, because the chairman's exposure to political bashing has perforce increased, our nation's defense against inflation has actually grown more fragile. Thus, it is no small irony that the more resounding the media's celebration of the sound money posture of a Paul Volcker or an Alan Greenspan, the greater the ultimate danger of monetary excesses.

The Increasing Politicization of Monetary Policy

Whether they promised to narrow or widen the after-election distribution of after-tax income, political campaigns of the past four decades have featured redistributive agendas. As the distribution of voting rights broadened relative to the distribution of earned income in the 1950s and 1960s, politicians were presented with glowing incentives to extend their power by promoting egalitarian income redistributions. John Kennedy's New Frontier and Lyndon Johnson's Great Society each featured a panoply of programs that promised to reduce income differentials. The leveling was reversed in the late 1970s when financing the redistributions of the previous decade created a middle- and upper-income taxpayer backlash. Astute politicians seized the moment by promoting status quo ante tax cut redistributions; the Kemp-Roth tax cuts are a good example.

It is widely recognized by public choice theorists that in a democracy direct transfers to rent-seeking interest groups are politically dangerous. Therefore, indirect transfers abound. Our monetary policy institutions are an important part of the indirection that envelops government redistributive programs. Modern macroeconomic theory teaches that, in order for monetary policy to have effects on interest and exchange, as well as unemployment rates, it must be able to surprise market participants. Thus, uncertainty about the way monetary policy will respond to outside pressures is essential.

Redistributive programs will gain political support to the extent that their adverse sectoral consequences can be made palatable. One way that politicians can do that is by publicly insisting that their redistributive programs serve high public purposes, such as fairness and justice. Another way is by draping their redistributive agendas in the mystique of macroeconomic externalities. For example, the New Frontier/Great Society redistributions of the 1960s were legitimated by appeal to Keynesian multiplier effects, and the tax cut redistributions of the 1980s were legitimated by allusion to supply-

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side growth effects. The conferral of legitimacy on an administration's redistributive programs is one of the most important functions of its economic advisers and their research networks in academia.

Politicians who find it difficult to make their redistributive programs palatable may subsequently attempt to mask the adverse consequences by influencing monetary policy. Variations in government expenditures and taxation invariably affect interest and exchange rates. Disincentives for productive effort that arise from government tax and transfer programs may also have adverse effects on growth and unemployment rates. When interest groups affected by the adverse consequences of redistributive policy generate sufficient flak, there is pressure on the Federal Reserve to "do something" (Hetzel 1990). Pressures can flow either directly, from interest groups, or indirectly, from interest groups through politicians.

Two kinds of evidence support the hypothesis that shifts in monetary policy are motivated by government redistributive programs' effects on interest and exchange rates. First, the historical record shows that the great money supply growth expansions under Presidents Johnson, Nixon, Carter, and Reagan were preceded by signals to the Federal Reserve to do something about adverse movements in interest or exchange rates that were the direct result of redistributive programs. Second, the growth rate of the money supply, as a dependent variable in estimated reaction functions, is significantly affected (statistically) by changes in the social expenditures of government, a measure of redistributive policies (Havrilesky 1987).

There is considerable evidence that over the last 40 years political pressure on Federal Reserve officials has grown intense. While continual executive branch pressure on monetary policy did not begin until the 1960s (Havrilesky, forthcoming), the stage for the increasing politicization of monetary policy was set when the Banking Act of 1935 elevated the power of the Federal Reserve Board and the Federal Open Market Committee (FOMC) at the expense of the Federal Reserve banks.[2] The ability to contain monetary excesses was further weakened by Congress's enjoinder to the Fed to promote high employment under the Full Employment Act of 1946. Additional erosion of monetary discipline took place when Congress abolished the ratio requirement of gold certificates to bank reserves in 1966

[2]The 1935 act removed from the individual banks the authority to authorize open-market operations and placed it in the newly created FOMC on which the banks had only minority representation. Despite that shift in the distribution of power, it would be a mistake to think that political pressure on the Federal Reserve did not begin until 1935. In 1935, Carter Glass observed that, as secretary of the Treasury, he dominated the board, as had his predecessors (see Timberlake 1986).

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and to Federal Reserve notes in 1968. In 1980, the Depository Institutions Deregulation and Monetary Control Act extended centralized control over the entire financial services sector. The politicization of monetary policy is further reflected in the steady erosion of private-sector influence within the FOMC[3] and in the mounting tension between politically appointed governors and privately selected, more militantly anti-inflationary Federal Reserve bank presidents (Murray 1991). Moreover, the scope of formal interactions between political principals and their central bank agents has greatly expanded, highlighted not only by the requirements of the Full Employment and Balanced Growth Act of 1978 but also by the growing influence of Federal Reserve officials on many aspects of government macroeconomic policy. Given those dramatic institutional changes, it should not be surprising that researchers have uncovered hard evidence of direct and systematic administration and congressional influence on monetary policy (Havrilesky 1988). The denouement of all that is that the politicization of monetary policy has proceeded coextensively with the movement toward an all-powerful Federal Reserve Board chairman.

Apparent Central Bank Autonomy

Greater political pressure on monetary policy is reflected in changes in the terms of trade between the Federal Reserve and the administration and Congress. Politicians have always granted the Federal Reserve a degree of immunity from outside pressure on its monetary policy decisions as well as regulatory domain and budgetary independence. In exchange, politicians have always had their way with monetary policy if necessary and have been able to bash their allegedly autonomous Fed whipping boys whenever anything has gone wrong and they have needed to let off political steam (Woolley 1984). Politicians influence monetary policy either by making politically reliable appointments to the board (Havrilesky and Gildea, forthcoming) or by signaling their preferences (Havrilesky

[3]That is revealed, for example, in the trend in the private- versus public-sector career characteristics of FOMC members. Over the 1960–88 period, the average years in private banking and private industry of FOMC members had negative trend coefficients that were significant at the 0.01 level. For further detail, see Havrilesky and Schweitzer (1990). Of course, at the same time that private-sector influence on the FOMC was decreasing, formal private interest group presence within the Federal Reserve bank directorates was increasing. That is reflected in the stipulations of the Federal Reserve Reform Act of 1977. Nevertheless, unless Federal Reserve bank authority on the FOMC is increased, that heightened private-sector representation on the directorates cannot reverse the trend toward the centralization of monetary power.

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1988). Recent research suggests that the degree of monetary policy responsiveness to such signaling depends on the political vulnerability of the chairman (Havrilesky, forthcoming). Federal Reserve leaders are obliged to tolerate, and periodically to succumb to, the pressure and to accede to the bashings, even as they play their roles as oracles of sound money and sound banking.[4]

Given that symbiosis, greater political pressure on Federal Reserve Board officials is not costless to politicians. In exchange, they have had to pay lip service to Federal Reserve autonomy.[5] In short, the greater the political pressure on the Federal Reserve, the greater the power of the chairman, and the more pronounced politicians' apparent concessions to Federal Reserve autonomy. Nevertheless, those concessions are not real. When 75 directors of Federal Reserve District banks were recently asked if the Federal Reserve is more vulnerable to a loss of autonomy today than 10 years ago, 43 said yes (Harrison 1991).

Implications for the Modeling of Monetary Policy

This paper has argued that after several generations of politicization of monetary policy, our nation's defense against inflation has devolved to the chairman of the Federal Reserve system. Thus, it is not surprising that each chairman (with the exception of William Miller) at least appears to have been more conservative than his predecessor. Unfortunately, media celebration of the chairman as an anti-inflationary hero is unlikely to protect this awesome responsibility from future political bashers bent on monetary profligacy.

Scholars and researchers should not ignore the changes. They should be skeptical of models that posit a mythic policymaker who independently formulates macroeconomic (intermediate targets and goals) strategies or interacts game theoretically with atomistic market participants, or both. The latter models display obeisance to the mechanistic formalism of a particular game-theoretic/rational expec-

[4]Private bankers are also part of the symbiosis. They receive favorable regulatory treatment from politicians and their Federal Reserve overseers and can also influence monetary policy if necessary but, given the popular aversion to bankers in politics, must avoid the appearance of doing so. Bankers also must come to the defense of the Fed whenever it is politically beleaguered and are, of course, expected to make generous campaign contributions to politicians, especially those involved with monetary and financial regulatory policy.

[5]Those concessions are illusory. An increase in political influence constitutes a decrease in genuine autonomy. That the Federal Reserve is not as autonomous as central banks in Switzerland and Germany is reflected in indices of relative central bank autonomy (see Alesina 1988). A number of empirical studies show that the less politicized (the more autonomous) a nation's central bank, the better its inflation performance.

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tations paradigm but have flimsy institutional premises (Persson and Tabellini 1990). Fundamentally, they ignore the public choice aspects of monetary policy that feature rent-seeking interest groups and portray politicians in the executive and legistlative branches as self-interested principals and central bankers as career-maximizing agents (Kane 1982, Woolley 1984). Public choice models recognize that uncertainty, misdirection, and the attendant social costs of the Fed's obfuscating, market participants' uncovering, and interest groups' lobbying for policy changes are fundamental parts of the wasteful rent seeking that permeates modern monetary policy. They do not mistake ceremonial genuflection at the icon of Federal Reserve autonomy that is a part of that misdirection for genuine central bank independence and public interestedness.[6] Public choice models explain the selection of chairmen and governors as the result of interaction among presidential electoral ambitions, the chairman's and governors' reappointment and career ambitions, and congressional oversight. So modeled, the selection of governors is a problem in choosing the political support-maximizing blend of reliable partisan and representative members of the board (Havrilesky and Gildea, forthcoming). The design of fruitful and practicable monetary reform is more likely to emerge from realistic multiple principals/multiple agents public choice models than from the institutionally naive game-theoretic genre.

Conclusion

Redistributive fiscal policies have required the increased politicization of monetary policy. This politicization has called for a weakening of formal institutional constraints on monetary excesses, the removal of the gold reserve ratio, and an increase in the power of the Federal Reserve Board, particularly that of its chairman. Given the symbiosis that exists among politicians, the Federal Reserve, and the financial services community, if politicians are more frequently to have their way with monetary policy, they must, in turn, grant more apparent autonomy to the chairman.

[6]Game-theoretic models would applaud the transfer of power to the apparently autonomous chairman and away from formal constraints as the substitution of a discretionary conservative central banker for precommitment to monetary rules on the grounds that rules are more easily broken than the resolve of the central banker (see Persson and Tabellini 1990, pp. 33–55). In contrast, public choice modeling would suggest that an ostensibly conservative central banker, being so subjected to the carrots and sticks of interest groups and politicians, is a far weaker defense against inflationary excess than even a breakable monetary rule.

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What will come of the present state of affairs is not difficult to predict. We have placed much of our institutional defenses against monetary excesses in the hands of one person, the chairman of the Federal Reserve. Because the chairman is apparently so autonomous, he can easily be blamed by politicians. Thus, his anti-inflationary authority is conspicuously fragile. Therefore, depending on his political vulnerability, given a sufficiently strong economic perturbation or sufficiently acute presidential disfavor, even the most resolute chairman will relent.

Because radical monetary reform is politically impossible unless an inflationary disaster occurs, it is unlikely that we will be able to abandon the current fiat money regime or impose inviolable money growth rules on it. Given those constraints, perhaps the best monetary reform that can be hoped for would have to be piecemeal. One practicable piecemeal reform might be to impose meaningful restrictions on political pressures on monetary policy and to enact penalties on central bankers who succumb to those pressures.[7] Another practicable piecemeal reform would be to legislate marginal increases in private-sector representation on the FOMC, not to benefit special interests but to check inflationary political pressures. Yet another practicable reform would be to lengthen the term of the chairman to reduce his political vulnerability.

In order for even those piecemeal reforms to be enacted, public choice reasoning suggests that they would have to generate sufficient benefits for some of the powerful actors in the monetary policy process. Perhaps if they gained genuine independence and relief from outside pressures, Federal Reserve officialdom and its constituency in the financial services sector would support such reform. In addition, perhaps promises of improved inflation performance and less wasteful rent seeking in monetary policy would generate support for reform from other sectors and from voters in general. Finally, even some politicians would support such reforms to the extent that they would gain relief from responsibility for monetary policy. In that manner, we can re-establish some formal institutional defenses against monetary excesses.

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[7]Some analysts such as Kane (1990) favor reforms that would place the Federal Reserve more directly under political control on the grounds that such reforms would reduce politicians' ability to disclaim responsibility for monetary misfortunes. In my opinion such gains would be outweighed by the inflationary losses, uncertainty, and wasteful rent seeking that would be likely to arise from a more complete politicization and

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centralization of monetary authority.

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Full Privatization of Currency in a Nearly Conventional Money and Banking System

W. William Woolsey

Introduction

Full privatization of currency is a reform that deserves serious consideration. Unfortunately, it is often taken to mean replacing a single government fiat money with multiple private moneys, each denominated in a different unit of account (Klein 1974, Hayek 1978). Currency privatization appropriately refers to the private issue of hand-to-hand currency: bank notes and token coins. Those notes and coins can all be denominated in a common unit of account.

The existing literature on private currency assumes free banking. Sometimes the emphasis is on historical banking systems that combined private currency with free entry and requirements for bond collateral (Rockoff 1974, Rolnick and Weber 1983, King 1983). At other times the emphasis is on historical banking systems that combined private currency with no restrictions on branching or reserve holdings (White 1984, Selgin 1988a, Dowd 1989, Glasner 1989, White 1989). But one common characteristic of the literature is the absence of a central bank and monetary policy.

Currency privatization deserves consideration on its own merits and requires an analysis of institutions that combine the full privatization of currency with an otherwise conventional money and banking system. Most important, a central bank must be able to implement monetary policy.

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Full privatization goes beyond permitting banks to issue currency. It requires that the government be removed from the business of issuing hand-to-hand currency. To provide an analogy, full privatization of the postal service goes beyond permitting private firms to compete for the delivery of first-class mail. The government postal service must be sold or closed down. Government would no longer be in the business of delivering mail.

Privatizing Currency

The full privatization of currency can be introduced without abolishing monetary policy. First, the issue of private notes and coins must be permitted. The simplest approach would be to allow banks to issue notes and coins on the same terms as checkable deposits. Any reserve requirements would have to be made equal for checkable deposits, notes, and coins.

Like checkable deposits, private notes and coins could be denominated in dollars. But they would be differentiated by the name of the issuing bank.[1] Moreover, like checks, notes and coins would clear through the Federal Reserve system (the Fed). As is now the case, each bank would deposit items drawn on other banks in the Fed, which would credit the depositing bank's reserve account and debit the reserve accounts of the banks on which the items were drawn. The Fed would then return the items to the banks on which they were drawn.

Full privatization of currency requires further steps to remove the government from the business of issuing currency. The Fed must withdraw all of its notes and Treasury currency from circulation.[2] And it must cease redeeming reserve accounts with Federal Reserve notes or Treasury currency. Further, any of the "old" currency that remains outstanding must lose its status as legal tender.[3]

The only remaining currency would be privately issued notes and coins. Members of the public could no longer withdraw base money

[1]That is not to suggest that banks should be prohibited from issuing notes and coins (or deposits) denominated in foreign currencies, Hayek's more fanciful units, or even precious metals.

[2]To remove government currency from circulation, the Fed might accept the items for deposit in reserve accounts at a slight premium for a short time, then at a progressively larger discount, and then not at all.

[3]George Selgin (1988a, pp. 168–71) has correctly argued that government hand-to-hand currency might serve as base money in a fully privatized system. The existing stock of government currency is privately owned. And if the government were prohibited from any new issues of currency, base money would be valued much like other limited-edition engravings. Of course, like the rest of the literature on private currency, the result is inconsistent with the Fed's implementing a monetary policy.

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(high-powered money) from their banks, because it would no longer exist in the form of hand-to-hand currency. Base money would exist only in the form of deposits in reserve accounts at the Fed, so it would be identical to bank reserves. While a single bank could obtain reserves by depositing items drawn on other banks at the Fed, that would simply transfer base money from the reserve accounts of the banks on which the items were drawn.

Even without government hand-to-hand currency, the money and banking system would be nearly conventional. The Fed could control base money and bank reserves by using discount policy or open-market operations.

Differences between Government Currency and Private Currency

Most laymen, and some economists, find private currency almost incomprehensible. But in evaluating currency privatization, it is essential to avoid confusing currency with money. Hand-to-hand currency is only one form of money. Checkable deposits are more important, both in volume of payments made and amounts held.

Perhaps some confusion arises because private currency is physically similar to government currency. But there is an essential economic difference. Government currency is important because it is base money. Checkable deposits and checks are claims to government currency.

Private currency is much less important because it is not base money. Checkable deposits and checks are not claims to private notes or coins. Instead, private checkable deposits, checks, notes, and coins are all claims to base money.

Determination of the Quantity of Money

Many laymen, and some economists, believe that private currency is inherently inflationary. The notion has superficial plausibility. Banks are assumed to use zero-interest currency to finance interest-bearing assets, so issuing more currency always adds to profits.

But a simple textbook derivation of the money multiplier shows that, if the reserve requirements for checkable deposits and private currency are equal and binding, the money multiplier is equal to the reciprocal of the required reserve ratio. The quantity of money is determinate and proportional to the quantity of base money. The currency-to-deposit ratio has no effect on the quantity of money and, instead, determines the division of the total quantity of money between private currency and checkable deposits. Further, the

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simplification of the money multiplier should make it easier for the Fed to use base money as an instrument to control the quantity of money.

Much of the free-banking literature is aimed at showing how an obligation to redeem notes, coins, and deposits with base money constrains the issues of banks without reserve requirements (White 1984, pp. 3–7). A bank has an incentive to hold the amount of reserves that it expects will be sufficient to meet its obligations.

Since the full privatization of currency requires that government currency be fully replaced by private notes and coins, banks would have no need to hold reserves to cover withdrawals of hand-to-hand currency. Still, they would have an incentive to maintain positive balances in their reserve accounts at the Fed to cover unanticipated, unfavorable, net clearing balances (Selgin 1988a, p. 72). The most profitable reserve ratio would depend on a tradeoff between the opportunity cost of holding reserves and the expected cost of running out of reserves.

The expected cost of running out of reserves depends on the probability that an adverse net clearing balance will deplete a bank's reserves and the cost of correcting the problem. Given the amount of reserves a bank holds, the probability that its reserves will fall to zero depends on the variance of net clearing balances, which depends on the gross expenditures of its depositors (Selgin 1989a, p. 82). The cost of obtaining the needed reserves is determined by the transactions costs of selling assets or obtaining loans.

Since the amount of reserves that banks choose to hold can change, abolishing reserve requirements would make it more difficult for the Fed to use base money as an instrument for targeting the money supply. But George Selgin (1989a, p. 84) has shown how the positive relationship between gross expenditures by depositors and the demand for bank reserves implies that a frozen stock of base money will stabilize aggregate expenditures. That implies that the Fed could use base money as an instrument for targeting nominal income.[4]

Supposed Inconveniences of Private Currency

Many laymen and economists assume that private currency would make payments inconvenient. Fortunately, there is no reason to expect privatized currencies to vary as much as the currencies issued

[4]Changes in the opportunity cost of holding reserves and the transactions (and liquidity) costs of obtaining reserves would also influence nominal income, complicating the Fed's efforts to target nominal income.

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by different governments. All of the private currencies would be denominated in dollars, and there would be little demand for inconvenient, nonstandard currencies. Further, the Fed (or a private clearinghouse) could regulate the different denominations offered, the positioning of information on the items, and the color of different denominations by refusing to accept nonstandard items for deposit in reserve accounts.

Variable discounts or premiums on different private currencies would greatly complicate transactions. But those are possible only in the absence of an effective clearing institution. Lawrence White (1984, pp. 18–21) has argued that banks have an incentive to increase the demand for their deposits, notes, and coins by agreeing to accept each others' items for deposit at par and then calculate and settle up net clearing balances. Assuming the Fed (or a private clearinghouse) clears notes and coins like checks, the likely result is that each private currency would be accepted at par or not at all.

Sometimes it is assumed that private currency would cause serious problems because of counterfeiting. Criminals might try to pass notes and coins drawn on nonexistent banks. A similar problem would occur if criminals were to purchase notes or coins drawn on failed banks at a discount and attempt to introduce them into circulation. To prevent such an enterprise, penalties analogous to those for counterfeiting government currency might be imposed for passing notes and coins drawn on failed or nonexistent banks.

While law enforcement is unlikely to stop all counterfeiting, it would probably be more effective than attempts to prevent counterfeiting of government currency. The clearing of notes and coins would involve more frequent expert examination of notes and coins at bank counters or the clearinghouse (Selgin 1988a, p. 149). If criminal investigations could begin more rapidly, counterfeiting would be discouraged.

Interest on Privatized Currency

Private currency is sometimes criticized because it deprives the government of a desirable source of revenue. When the demand for currency is growing, the government can finance its expenditures with newly issued currency instead of with taxes, which distort economic decisions and reduce welfare. And even when the demand for currency is not growing, nationalized currency allows the government to borrow at a zero nominal interest rate. By borrowing at less than market interest rates, the government earns rents that can be substituted for taxes.

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Banks would compete away and eliminate any rents that might be obtained from issuing private currency. Since paying explicit interest on currency is inconvenient (Fama 1983, pp. 12–13; White 1989, p. 248), banks could compete by providing services desired by those holding their currency.

Lawrence H. White (1984, pp. 7–8) has discussed many services that banks might provide. He suggests extending operating hours; increasing the number of tellers; adding bank branches; increasing advertising of the availability of added services; building impressive buildings; engaging in "image" advertising; and improving design, watermarking, and engraving of currency.

J. Huston McCulloch (1986, p. 75) has explained that banks could make payments to currency holders by means of a currency lottery. The currency would serve as the lottery tickets. To prevent currency withdrawals immediately before drawings, Tyler Cowen has suggested random drawing times (White 1989, p. 374). While not equivalent to explicit interest, the expected return would make a bank's currency more attractive to hold.

Banks could also eliminate rents by paying higher interest on their checkable deposits. Such competition would occur if banks' market shares in the currency business were positively related to their market shares in the deposit business.

The relationship is plausible. Currency enters circulation as households cash checks or withdraw currency from their checkable deposits for use in small, face-to-face retail transactions. Retailers also withdraw currency from their checkable deposits to make change and cash checks.

Checks and checkable deposits dominate financial transactions and income payments, as well as payments in manufacturing and distribution. Hence, retailers' payments are made by check, and most of the currency they receive in payment is deposited at their banks.

As suggested by Knut Wicksell (1935, p. 88), private notes and coins are best understood as a special sort of check, certified by the issuing bank and made out in a convenient round amount. The rents a bank could earn from issuing currency are similar to interest earned from "float" and are closely related to the bank's market share in the deposit business.

Of course, different depositors withdraw different amounts of currency. That would give banks an incentive to discriminate by classes of depositors. Manufacturers could receive relatively low interest rates on their checkable deposits because they put little currency into circulation. Households could receive somewhat higher interest rates. Retailers could receive relatively high interest rates because

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of their withdrawals of currency for change. Liquor or grocery stores in poorer neighborhoods could receive even higher interest rates because they put currency into circulation as their customers cash their pay checks. Similarly, deposit banks could earn relatively high interest rates on their correspondent balances if they put substantial amounts of their correspondent's currency into circulation.

Robert E. Hall has suggested a procedure that would allow a bank to pay each depositor all the rents the bank earns on the currency the depositor puts into circulation. The bank would credit the interest to the depositor's checkable deposit (Hall 1986, p. 226).[5] The procedure would require that banks record the serial numbers of notes or coins when they are withdrawn. If the depositor held the currency, he would continue to earn interest. If he spent the currency, he would continue to earn interest until the items were cleared and returned to the bank.

McCulloch (1986, p. 75) has criticized that approach, because those receiving currency in payment receive no interest. But to be successful, his criticism requires the implausible assumption that private currency would normally remain in circulation for extended periods of time because people receive currency in payment and then use it to make purchases.

But private currency is likely to be withdrawn from a bank, spent, deposited in a bank, and then cleared through the Fed. Given the short period for which private currency would be held, retailers would be unlikely to discriminate between currencies according to the services or lottery payments provided by different banks (Sumner 1990, p. 13). And surely, retailers would find it too costly to allow customers to choose the "brand" of notes or coins to be received as change.

Of course, maintaining the necessary records would be costly (McCulloch 1986, p. 74). That explains why the approach was not used in the past. In the future, improved recording devices and data storage would probably force banks to dissipate any rents from issuing zero-interest currency by directly paying the interest into their depositors' checkable deposits.

So one of the benefits of privatizing currency is that the public would receive additional benefits from the banking system. Only a competitive market process can determine if people prefer higher quality currency, more services, currency lotteries, more interest

[5]Hall suggests crediting interest to VISA accounts, which seems pointless. Still, borrowers (including those drawing on VISA accounts) might be charged a lower interest rate for currency advances until borrowed notes and coins were returned to the bank.

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on their checkable deposits, or some combination. Nationalizing currency to obtain government revenue is desirable only if confiscating the benefits the public receives from the private issue of currency causes less distortion than taxing other goods or services.

Special Problems with Full Privatization of Currency

Full privatization of currency involves complications and disadvantages that are not associated with the private issue of currency. One complication involves the contractual relationship between banks and their depositors. In traditional systems, a government hand-to-hand currency or one of the precious metals serves as base money. Checks and checkable deposits (and private notes and coins) can be understood as claims to base money because depositors can demand that their banks provide it in redemption. Alternatively, items could be made indirectly convertible by allowing depositors to demand from their banks whatever variable amount of gold or securities is equal in market value to a broad bundle of goods and services (Greenfield and Yeager 1989).

The full privatization of currency described in this paper makes checks, notes, and coins claims against deposits in reserve accounts at the Fed. But depositors (and note and coin holders) cannot directly hold deposits in reserve accounts, so those claims can be exercised only through the intermediation of another bank. Superficially, it seems that existing depositors are at least partly expropriated when government hand-to-hand currency is abolished.

While the reform does involve a change in the relationship between banks and their depositors (and note and coin holders), the banks can hardly be held responsible for a breach of contract if the government imposes a reform that demonetizes what they had promised to provide in redemption. As for the government, it is difficult to portray ending the redemption of reserve accounts with Federal Reserve notes as a breach of contract with the banks. The government defaulted when the Fed ceased redeeming reserve accounts (and Federal Reserve notes) with gold.

Further, the obligation of banks to cover adverse clearings with funds from their reserve accounts should not be dismissed. Kevin D. Hoover (1988, p. 158) has argued that a monetary system must have some ultimate good of conversion if contracts are to be more than claims to claims. Reserve accounts at the Fed can serve that purpose. Assuming contracts make no specific provision, creditors might be required to accept checks, notes, and coins drawn on any bank, but

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the debt would only be discharged once the items were successfully cleared through the Fed.

Also, the obligation to cover adverse clearings with funds from reserve accounts keeps the purchasing power of the checks, deposits, notes, and coins issued by any one bank tied to the purchasing power of both the items drawn on other banks and the deposits in reserve accounts at the Fed. Of course, the purchasing power of all that money depends on the Fed's monetary policy. So any change in contracts or property rights implied by the full privatization of currency is best understood as an insignificant change in the details of what remains a system of government fiat money.[6] A more relevant concern is the possible disadvantages of abolishing government hand-to-hand currency.

One disadvantage would be the need to examine notes and coins tendered to determine if they are drawn on a sound bank. Permitting the private issue of currency is not subject to that difficulty, because sellers or creditors can always insist on payment with government currency. They will accept only private currency when they find it worth the trouble (White 1989, p. 254). Full privatization of currency forecloses that option.

But currency is used mostly for small, face-to-face retail transactions and illegal transactions. Few want to make illegal transactions more convenient. So at worst, full privatization of currency might make certain retail transactions less convenient.

If retailers felt compelled to accept currency drawn on 10 thousand unit banks, examining all the different notes and coins would be a serious problem. But retailers could accept only currency drawn on a limited number of banks. Even if currency were fully privatized in the near future, there would probably exist a limited number of nationally branched banks. Currency drawn on all of those major banks could be accepted under normal circumstances. Only occasionally would it be necessary to watch for items drawn on a bank that had failed or was in imminent danger of failing.

A second disadvantage would be that members of the public would sacrifice whatever welfare they could obtain by holding government-issued currency in their portfolios. But the primary benefit of government-issued currency is the absence of default and interest-rate risk. Members of the public could do nearly as well (and probably better) by holding shares in mutual funds made up of interest-bearing government

[6]Concerns about the status of property rights and contracts have been emphasized by George Selgin in conversation and correspondence.

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bonds that are nearing their maturity dates. Such bonds are equally free from default risk and nearly as free from interest-rate risk.

Runs on the Banking System

While full privatization of currency implies some special disadvantages, it also provides some important advantages. A run on the banking system cannot possibly cause a reserve drain, decrease in the money supply, and macroeconomic contraction.

Admittedly, there is reason to doubt that runs on the banking system cause macroeconomic contractions. Some research suggests that widespread bank failures have instead been caused by macroeconomic contractions (Rolnick and Weber 1986, Selgin 1989b). Widespread branching and adequate capital ratios have been able to prevent bank failures despite macroeconomic contractions (Kaufman 1988, p. 568; Ely 1988, pp. 54–55).

There are still plausible arguments that banks are subject to runs and that runs can cause severe harm. Financial intermediation can be subject to self-fulfilling expectations. Banks free investors from the need to obtain and interpret specialized information about the credit risks of borrowers. But that implies that depositors, investors, and other banks are relatively ignorant of a bank's loan portfolio. They can falsely believe that a bank is likely to become insolvent (Goodhart 1988, pp. 96–102).

Banks also create liquidity. They borrow from depositors at a shorter term to maturity than they lend to borrowers (Diamond and Dybvig 1983). So a run on a bank can develop if many depositors believe that a bank is likely to become insolvent. They will refuse to lend new funds and will immediately withdraw funds from their checkable deposits. The bank must liquidate assets.

A run on the banking system can develop if many depositors believe that each bank is likely to become insolvent. They may recognize that some banks will remain solvent, but if they cannot identify those banks, they withdraw base money and cause a reserve drain. As banks scramble for reserves, they all must liquidate assets. Since it is impossible for all banks to find buyers given current market prices, the market value of the banks' asset portfolios must decrease.

Further, the reserve drain causes a multiple contraction in the money supply. The resulting contraction of expenditures leads to decreased real activity and prices. Both imply that firms and households have greater difficulty meeting loan payments. The bankruptcies that ensue adversely affect the value of banks' asset portfolios (Friedman and Schwartz 1963, pp. 167–68).

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So beliefs of depositors about the solvency of the banking system can cause bank runs and a macroeconomic contraction, which can cause many banks to become insolvent. Worse, since false beliefs can cause banks to fail, a single depositor must be as concerned with the beliefs of other depositors as with the facts. If a depositor believes that many other depositors believe that each bank is likely to become insolvent, he will withdraw his funds from the banking system.

The intersubjective indeterminacy of that situation makes self-fulfilling expectations more likely. And even if history suggests that the probability of such a problem is low, the harm resulting from a macroeconomic contraction is potentially great. After the banking crisis of the 1930s, the creation of institutions aimed at preventing that harm was probably inevitable.

Deposit Insurance

Fear of the consequences of runs on the banking system has generated broad support for universal government deposit insurance. It appears to be an ideal solution. Since depositors suffer no risk of loss, they have no incentive to withdraw funds from banks they believe might fail. Therefore, bank runs do not develop, so neither a solvent bank nor a solvent banking system can fail because of false beliefs. Further, the government's power to tax implies that it can credibly guarantee all deposits without building up a reserve (Diamond and Dybvig 1983, p. 416).

But it is generally recognized that deposit insurance creates a serious moral hazard problem (Kareken and Wallace 1978) that is unfortunately exacerbated by competition. When freed from risk of loss, depositors are concerned only with return. From their point of view, lack of geographic or product diversification and low capital ratios are unimportant. Competition forces banks to take excessive risks to pay high returns.

So government deposit insurance makes bank regulation essential. Since regulators must be relatively ignorant of the characteristics of banks' loan portfolios, perfect regulation is impossible. Worse, the savings-and-loan crisis of the 1980s shows how regulation can be aimed at providing concentrated benefits to special interests rather than promoting the diffuse interest of taxpayers in reducing bank risk.

Lender of Last Resort

If the Fed serves as the lender of last resort, runs on the banking system can be made harmless. If a run occurs, the Fed can lend

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newly created base money to the bank involved. Since loans from the Fed prevent the failure of solvent banks, depositors do not need to consider the beliefs of other depositors. Further, loans from the Fed signal all depositors that a bank will not fail. The result should be the end, and rapid reversal, of any run.

If the Fed limits loans to solvent banks, depositors have an incentive to avoid risky banks. They will choose banks that hold diversified asset portfolios and adequate capital. Unlike universal deposit insurance, a lender of last resort is consistent with substantial bank deregulation.

But the Fed can easily abuse its ability to serve as lender of last resort. An excessively conservative policy can be disastrous. If the Fed fails to immediately lend to solvent banks, runs and the resulting macroeconomic contraction can cause many banks to become insolvent. So strict collateral requirements or rules against lending to insolvent banks can prevent the Fed from ending a crisis caused by its own tardiness. Excessive conservatism on the part of the Fed was responsible for the banking crisis of the 1930s (Ely 1988, p. 59).

Unfortunately, an excessively liberal policy can also be disastrous. If the Fed consistently lends to insolvent banks, depositors can leave their funds in risky and even insolvent banks. That implies that runs might never actually develop. Of course, a liberal lender of last resort causes the same moral hazard problem that is caused by universal government deposit insurance (Goodhart 1988, p. 7–8).[7]

Further, the savings-and-loan crisis of the 1980s shows how political pressure can be brought to bear to prevent the concentrated harm caused by the failure of an insolvent bank rather than the more diffuse harm caused by a risky banking system. Perhaps the Fed insists on regulation of the banking system because it recognizes that political pressure makes it difficult to allow insolvent banks to suffer runs and fail.

Full Privatization of Currency as a Substitute

Universal government deposit insurance or a liberal lender of last resort will continue to cause a moral hazard problem that requires the associated regulations until some substitute method of preventing a

[7]The Fed can be required to use only open-market purchases to offset a reserve drain. That avoids the moral hazard problem since no loans are made to banks, but a repetition of the Fed's failure in the 1930s is always possible.

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repetition of the banking crisis of the 1930s is found. Fortunately, full privatization of currency is a possible substitute.[8]

George Selgin argues that some of the currency withdrawals associated with a macroeconomic contraction are caused by reduced acceptability of checks (Selgin 1988b, p. 110; 1989b, p. 446). If banks are permitted to issue currency, they can meet that sort of run by adjusting the composition of their liabilities without causing a decrease in the money supply (Selgin 1988b, p. 626; Horwitz 1990, p. 647).

Of course, if many depositors believe that banks may become insolvent, the result can be a run for base money. In a fully privatized banking system, a run for base money is impossible. Fears about the solvency of banks provide no reason to exchange checkable deposits for private currency. And if depositors spend checks, notes, and coins on other assets, those selling the assets must accept checkable deposits, notes, or coins. There can be no reserve drain, decrease in the money supply, and macroeconomic contraction.

Lloyd Mints described the benefit of privatized currency in a peculiar way. He pointed out that traditional money and banking systems effectively require 100 percent reserves for currency and only fractional reserves for checkable deposits. He argued that the system was inherently unstable. While Mints (1950, p. 6) advocated 100 percent reserves for checkable deposits, he recognized that his logic applies equally to a system that allows currency to be issued against fractional reserves.

Runs on a Single Bank

Private currency does not prevent a run on a single bank. If depositors believed a bank might become insolvent, they could deposit their currency or checks in new accounts at other banks. After the deposited items cleared, the depositors could write checks or withdraw currency from their new accounts.[9]

The bank suffering the run would suffer adverse clearings and lose reserves to other banks. If it could not obtain sufficient items drawn

[8]An alternative approach is a temporary restriction on or suspension of cash redemptions (Timberlake 1984, pp. 11–12). An option clause could be used to contractually determine appropriate interest penalties (Dowd 1989, pp. 27–31; Selgin 1989b, pp. 454–55). A possible problem is that an insolvent bank might take large risks during a suspension.

[9]If insolvency becomes obvious before the items clear, the depositors shifting funds to new banks as well as those who left funds in the failed bank will suffer losses. Those who believe they will consistently be first in line for base money would prefer a conventional system. But those who fear they will be unable to remove base money before a bank closes would benefit from full privatization.

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on other banks by liquidating assets or borrowing, it would soon run out of reserves and be unable to cover its adverse net clearing balance. A single bank could fail.

Since banks could fail, depositors would have an incentive to choose banks that had properly diversified asset portfolios and adequate capital. Full privatization of currency avoids the moral hazard problem implied by universal deposit insurance or a liberal lender of last resort.

Private Deposit Insurance or Lender of Last Resort

Unfortunately, full privatization of currency is consistent with a single bank's failing because of the false beliefs of depositors. But if runs on the banking system can cause no reserve drain and macroeconomic contraction, deposit insurance or the lender of last resort could be privatized.

Private deposit insurance might not survive a reserve drain and macroeconomic contraction, but it could provide limited protection against insolvency while controlling the moral hazard problem. Perhaps the most important service it could provide would be to monitor and control bank risks for relatively ignorant depositors, mostly by insisting on appropriate diversification and adequate capital.

Similarly, a private lender of last resort might not be able to borrow sufficient funds if a run on the banking system caused a reserve drain and macroeconomic contraction. But a specialized firm or firms could analyze the loan portfolio of a single bank suffering a run. Assuming they were willing to risk their own capital, such firms could borrow funds and lend to a solvent bank.

Conclusion

Full privatization of currency requires that government currency be fully replaced by privately issued bank notes and token coins. Unlike government currency, private currency is not base money. Rather than circulate, it clears through the Fed like checks.

Binding reserve requirements are sufficient to determine the quantity of money. Because the money multiplier is greatly simplified, the Fed can easily use base money as an instrument to implement a money supply rule. In the absence of reserve requirements, banks would hold reserves to cover adverse net clearing balances. Because of the positive relationship between the demand for bank reserves and payments by depositors, the Fed might be able to use base money as an instrument for targeting nominal income.

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The most important benefit of the full privatization of currency is that runs on the banking system cannot possibly cause a reserve drain, decrease in the money supply, and macroeconomic contraction. Since runs on individual banks remain possible, the full privatization of currency avoids the moral hazard problem implied by universal deposit insurance or a liberal lender of last resort. So, full privatization of currency would allow for bank deregulation and avoid a repetition of the banking crisis of the 1930s or the savings-and-loan crisis of the 1980s.

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Welfare Gains from Innovation-Induced Rent Seeking

Alden F. Abbott and Gordon L. Brady

Introduction

Standard economic analysis equates the creation of monopoly power with reductions in welfare. The modern literature has stressed the deadweight costs (Harberger 1954) and the rent-seeking costs of monopoly that arise from competition for monopoly returns (Tullock 1967). Assuming perfect competition for monopoly rents, the total cost of monopoly power is a trapezoid, composed of the triangle of lost consumer surplus ("Harberger costs") plus the rectangle of monopoly profits devoted to rent-seeking activities ("Tullock costs") (Posner 1975). More recently, it has been suggested that because rent-seeking costs are largely sunk costs that cannot be recouped under most conditions, the monetary returns from deregulation may be smaller than previously thought (McCormick, Shughart, and Tollison 1984).

The basic point of this paper is that the net accretion of surplus is what matters, not the individual losses in specific markets. By lifting regulatory impediments, deregulation may open new markets (which would create new demand curves) that would not have existed without such institutional changes. Admittedly, the loss in consumer surplus due to the initial establishment of regulatory regimes is capitalized and, hence, sunk. However, by limiting the focus of deregulatory analyses to the monopolization of an existing market rather than the creation of new markets, the potential gains from

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deregulation are understated (McCormick, Shughart, and Tollison 1984). We argue that summing monopoly losses across the economy overstates the cost of monopoly because some markets would not exist without the prospects of rents. Our argument is, of course, subject to the usual criticism of partial equilibrium analysis (i.e., improving competition in one market will not necessarily increase the economy's aggregate surplus).

In this paper, we depart from standard models and focus on the role of rent seeking in the creation of new markets, rather than in the monopolization of pre-existing, competitive markets.[1] When monopoly power is created in new markets that would not have existed but for rent seeking, the presence of Tullock and Harberger costs is associated with net increases in welfare (Abbott and Brady 1990). That follows from the fact that new markets yield net accretions to social surplus, even when Tullock and Harberger costs are fully taken into account. Accordingly, any attempt to measure the aggregate welfare costs of monopolization merely by adding Tullock and Harberger costs economy-wide may substantially overstate the burden of monopoly.

Our analysis is also noteworthy in that it examines the possible role of rent seeking in driving regulatory reform. Rent seeking may be crucial to the removal of regulatory obstacles that retard innovation and, thereby, impede the development of new markets. An insight afforded by that analysis is that, even if the sunk costs of regulation cannot be recovered, deregulation may be highly beneficial; the gains from deregulation may go far beyond the elimination of Tullock and Harberger costs that are not yet sunk.

The Economics of Rent Seeking to Promote Regulatory Reform

Consider a hypothetical regulatory regime that precludes firms from employing particular cost-reducing innovations in the production process. We assume that inefficient restriction was established and has remained in place because it has benefited a coalition composed of (1) bureaucrats who wish to maintain strict regulatory controls over industry, (2) firms and workers with political capital in the existing system (entrenched existing firms and unions that seek to minimize competition from potential entrants and cost-reducing competitors), and (3) third-party public interest groups that advocate intrusive regulation.

[1]As discussed below, air pollution control serves as a possible example of a regulatory regime whose efficiency might be enhanced through such rent seeking.

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Now let us assume a counter-coalition is formed to lobby for removal of the restriction on the introduction of innovations. The counter-coalition consists of firms that hope to market innovations after the regulatory constraints are lifted. Those firms are motivated by the expectation of earning quasi-rents in the sale of products that embody their innovations.[2]

Figure 1 shows the innovative products industry that comes into being as a result of the counter-coalition's success.[3] Compared with the competitive ideal of Q_n sales at a price of P_n per unit, Q_m units are now sold at a price of P_m per unit. Rent seeking by counter-coalition members absorbs resources represented by rectangle T, Tullock costs, and creates Harberger costs represented by triangle H. Those costs are associated with a net increase in, rather than a diminution of, social welfare, since the innovative products market would not have come into being but for the counter-coalition's rent seeking. Therefore, rectangle T merely offsets the gain in producer surplus attributable to the creation of the new market—it does not constitute a waste of pre-existing surplus. Triangle H should not be included in welfare calculations at all. Triangle H merely represents forgone gains in consumer welfare that could have been realized through the supply of additional units of innovative products[4]—not the destruction of pre-existing surplus through a post-monopolization

[2]That expectation might, for example, reflect an intent to rely on legal institutions that facilitate the appropriation of rents, such as patent or trade-secret protection. Alternatively, counter-coalition members might believe that market-specific entry barriers would allow them to price their products above marginal cost for a considerable period of time.

[3]The marginal revenue function is omitted to avoid cluttering the diagram. We employ a partial equilibrium framework and assume that the allocation of resources to the innovative products industry does not yield economy-wide resource shifts that, in the aggregate, lower welfare. We also assume, for purposes of simplicity, a constant long-run marginal cost function for rent seeking (LRMC). While the functional form need not hold (Tullock 1980), our result that welfare is raised in the innovative products industry is not affected, as long as some consumer surplus (portrayed as triangle CS) is created. Furthermore, we also ignore the possible costs arising from the wasted efforts of the beneficiaries of regulation to lobby against deregulation. We believe that omission is reasonable. Such beneficiaries may be reluctant to invest substantial resources in defending a regulatory restriction that is likely to be eliminated because lobbying has publicly spotlighted its harmfulness. Moreover, given the likelihood of additional spillover benefits to innovation, we believe it eminently reasonable to assume that lifting regulatory restrictions will raise net welfare, even taking into account possible wasteful counter-lobbying by beneficiaries of the regulatory status quo ante.

[4]Of course, those additional gains in surplus would have required pricing at marginal cost, a result inconsistent with the existence of appropriable quasi-rents (also represented by rectangle T). The counter-coalition that brought the innovative products market into being would have had no incentive to lobby for regulatory reform had it been denied the opportunity to obtain such quasi-rents.

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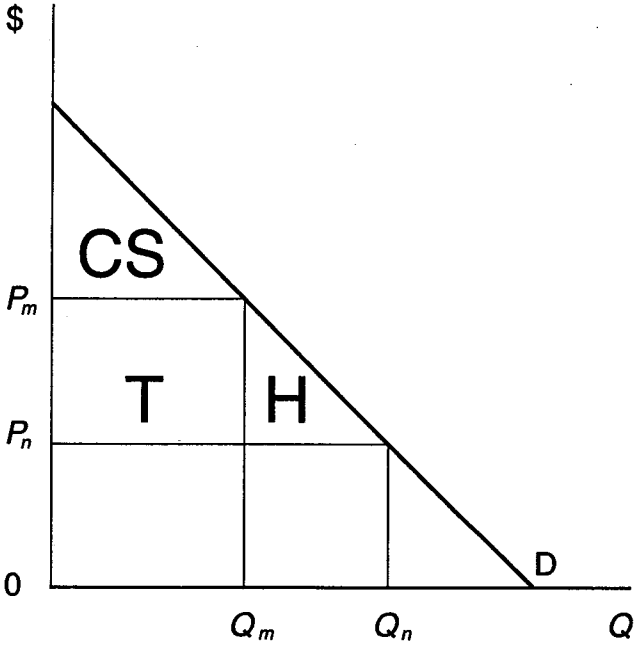
FIGURE 1
INNOVATIVE PRODUCTS INDUSTRY



production cutback in an existing market. However, triangle CS represents an unambiguous gain in consumer surplus accruing to purchasers of innovative products in the form of cost reductions that could not have been achieved without rent seeking by innovative products suppliers. In short, rent seeking to lift regulatory barriers to innovation yields unambiguous net welfare gains equal to triangle CS.

Additional benefits may also flow from such rent seeking. Given the imperfect appropriability of research and development (Jaffe 1986; Mansfield, Schwartz, and Wagner 1981; Levin, Klevorick, Nelson, and Winter 1986), some of the knowledge derived in connection with the introduction of new products may spill over to firms other than new product suppliers. That allows such third-party firms to reduce their costs.[5] Consider Figure 2, which shows cost reductions accruing to third-party firms in the widget industry (which is inde-

[5]Research that finds substantially higher social than private rates of return on research and development in a variety of industries, due to spillover cost reductions, is summarized in Bernstein and Nadiri (1988) and Mansfield (1988).

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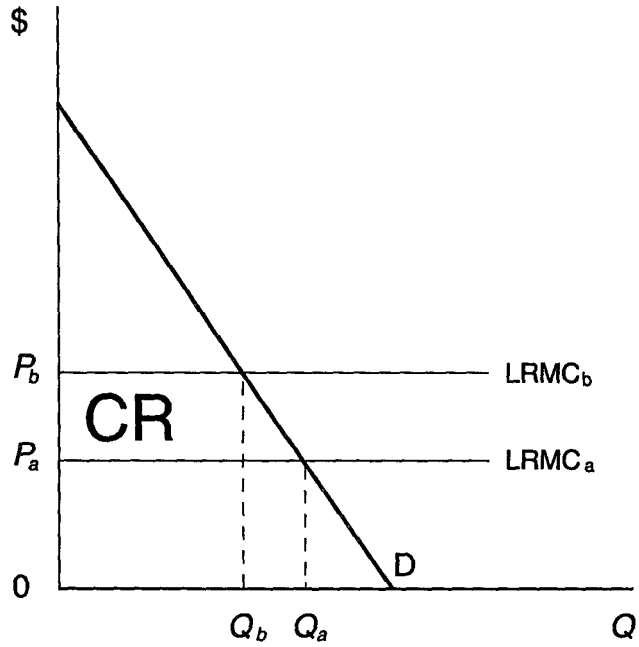
FIGURE 2
THIRD-PARTY EFFECTS



pendent from the innovative products industry). Those cost savings shift the widget industry's supply curve (long-run marginal cost) from $LRMC_b$ to $LRMC_a$, yielding net gains in consumer surplus equal to trapezoid CR.[6]

In sum, rent seeking that eliminates inefficient regulatory restrictions and, thereby, allows the introduction of new markets raises rather than lowers welfare. Tullock costs are more than offset by additional surplus created in the new markets, and Harberger costs merely represent additional potential welfare gains that cannot be realized, rather than the destruction of existing surplus. Further

[6]For purposes of simplicity, third-party firms are portrayed as belonging to one industry (if they resided in different industries, spillover benefits would involve reductions in a variety of distinct, industry-specific, long-run marginal cost schedules). Also, perfect competition is assumed, causing all the welfare gains to accrue to consumers. Under imperfect competition, the aggregate gains would be smaller because of the existence of deadweight welfare losses (Harberger triangles). Moreover, those reduced gains would be shared by producers and consumers in the form of additional consumer and producer surplus. The fundamental point remains, however, that spillover cost reductions to third-party firms would unambiguously raise welfare, whether or not competition were perfect.

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accretions to surplus may flow from spillover benefits of innovation (cost-reducing advances in knowledge) to third parties.

Rent Seeking in Air Pollution Institutions

Air pollution control in the United States is an example of a system in which rent seeking might reform regulation and raise welfare by facilitating innovation (Brady, Maloney, and Abbott 1990). That system, established pursuant to the 1970 Clean Air Act, imposes technology-based emissions limitations as a means of achieving desired ambient concentration levels for various air pollutants. The approach was reaffirmed in the 1990 amendments to the act.

The Environmental Protection Agency (EPA) established the framework for a limited market in pollutant permits in 1974. However, EPA trading rules inefficiently constrain intrafirm and interfirm trade. Prohibitions on trading between existing firms and new sources, and limitations on trading by firms that shut down for any reason, cause firms to extend the lives of old, more heavily polluting capital stock and delay the introduction of new, more cleanly operating plants (Maloney and Brady 1988). While that "retirement delay" effect directly retards innovation by keeping existing equipment in operation, EPA regulations also discourage innovation by preventing firms from introducing less-expensive, innovative pollution control equipment or processes. For example, those regulations prohibit firms from controlling pollution through more cost-effective methods that include converting to naturally low-sulfur fuels (such as natural gas or low-sulfur oil) or processed fuels, or to equipment that has not received EPA recognition as the "best available technology."[7]

Lifting the existing EPA restrictions on emissions trading would reduce the cost of achieving a given degree of air pollution abatement. It would allow firms with the lowest cost structures to purchase rights to pollute and spur the introduction of new technologies and the retirement of obsolete equipment.[8] However, public choice analysis suggests that such a change would be a disadvantage to entrenched firms, bureaucrats, and environmentalists that have a stake in the retention of the current system of complicated trading rules (Brady, Maloney, and Abbott 1990). Accordingly, the revocation of those rules may require lobbying (rent seeking) by a coalition of

[7]For a discussion of the monopolies created by equipment specification and various laws, see Ackerman and Hassler (1981) and Yandle (1989).

[8]The knowledge associated with the development of those new technologies might also bestow spillover, cost-reduction benefits on third-party firms in areas other than pollution control.

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firms that would benefit from unconstrained pollution rights trading, including purveyors of more cost-effective pollution control innovations that hope to develop a new market for their products. The existence of appropriable quasi-rents (obtainable, for example, through the use of patents or trade secrets) might be required to induce such lobbying. In sum, consistent with our prior model, it is presumed that rent seeking that succeeded in liberalizing pollution rights trading would raise welfare.

Policy Implications

We have shown that rent seeking that succeeds in lifting regulatory restrictions and, thereby, brings forth markets for products that embody new technologies raises rather than diminishes welfare. That is because the gains in surplus in the new markets more than offset rent-seeking costs.

A separate but related point is that monopoly power exercised in new markets that would not have come into being but for the profit-seeking activities of entrepreneurs and scientists (for example, new genetically engineered drugs that are developed solely because of the prospect of patent protection) should be viewed differently from monopoly power exercised in formerly competitive markets.[9] In the former case, as in the case of regulatory reform that lifts barriers to innovation, there is a net increase in welfare; welfare effects are measured by subtracting Tullock costs from the larger sum of consumer and producer surplus brought forth by a new market.[10] In the latter case, there is a decline in net welfare measured by the sum of Tullock and Harberger costs, with no countervailing growth in surplus, since no new market has come into being.

It follows that the overall welfare effects of monopoly power should not be derived merely by summing Tullock and Harberger costs across industries in which market power is exercised. Such an aggregate measure should be reduced by the sum of new surplus plus

[9]We distinguish profit-seeking activities that directly bring forth innovations in the absence of regulatory obstacles (for example, research and development expenditures) from the previously discussed rent-seeking lobbying activities that yield regulatory changes required for the introduction of innovations. Of course, profit-seeking activities may also involve some Tullock costs. For example, rival firms competing for a patent monopoly may wastefully duplicate some research.

[10]As in the case of rent seeking to overturn regulatory obstacles to innovation, discussed previously, Harberger triangles should be ignored. Those triangles merely represent potential additional surplus that was not realized, rather than welfare losses from the inefficient reduction in output as a competitive market is transformed into a monopolized market.

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Harberger triangles in imperfectly competitive markets that would not have existed without profit-seeking initiatives, including regulatory reform efforts.[11] Accordingly, Posner's (1975) suggestion that monopoly costs may account for as much as 4 percent of GNP, derived by adding estimates of Harberger (1 percent of GNP) and Tullock (3 percent of GNP) costs, may significantly overstate the welfare burden of monopoly.

A final implication of our analysis is that deregulation may bestow substantial welfare benefits on the economy even if the rent-seeking costs that first brought forth regulation cannot be recouped. As we have seen, to the extent deregulation yields cost-reducing innovations that would not otherwise have existed, surplus may be created both in a newly formed industry that sells innovative products and in unrelated industries that enjoy spillover benefits from innovative activity. The possible existence of significant welfare benefits creates a public policy rationale for regulatory reform in appropriate areas, such as air pollution control, even if previously incurred Harberger and Tullock costs are permanently lost to the economy.

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[11]Consistent with our prior discussion, Harberger costs in such "innovation-driven" industries would not be counted at all. The subtraction of Harberger triangles would exactly counterbalance their inclusion in the original economy-wide aggregation of welfare costs.

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Privateering and the Private Production of Naval Power

Gary M. Anderson and Adam Gifford, Jr.

> The early history shows that, contrary to the belief of many economists, a lighthouse service can be provided by private enterprise. . . . The lighthouses were built, operated, financed, and owned by private individuals. . . . We may conclude that economists should not use the lighthouse as an example of a service which could only be provided by the government.
>
> —Ronald Coase (1974)

Introduction

Privatization and the "contracting-out" of services traditionally provided by means of governmental monopoly continue to attract increasing interest from both politicians and scholars. Many studies have found that private provision of certain goods and services tends to be more efficient than comparable arrangements provided directly by the government.

One of the very few areas relatively untouched by the recent attempts at privatization, or contracting-out, of governmental services is the military. Although some economists have argued that the privatization of major elements of the provision of national defense would be both feasible and efficient, in modern times military forces are essentially a pure governmental monopoly. Not only are private military forces illegal, but the military force maintained by the government is invariably wholly owned and operated by the government. National defense, like lighthouses, frequently serves as a stylized illustration of the need for governmental provision of "public goods" in economics textbooks.

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However, just as in the case of lighthouses, the "monopolization" of military force production by the government is a fairly recent historical trend. During wartime, nations have long depended on hired private contractors for a portion of their military might.[1] At sea, until the 19th century, a significant portion of the naval power of many countries was provided by privateers.

Privateers were privately owned and operated vessels that were granted licenses to seize the shipping assets belonging to the citizens of enemy states and to sell the "prizes" at auction. Privateers preyed on the seaborne communications of enemy nations. The granting of licenses to privateers to legally attack and seize enemy ships during wartime appears to have constituted an effective means of waging war and had many advantages from the standpoint of the licensing government. Privateering played a significant role in the history of naval warfare for many centuries. During some wars, licensed privateers provided the bulk of the naval power employed by one or all of the belligerent powers.

Our intention in the present paper is to examine interesting examples of the private production of military power and the complex system of international law that emerged to regulate the practice. We will then proceed to consider possible explanations for the eventual demise of a seemingly efficient military institution.

Military Importance of Private Contractors for Waging War at Sea between 1600 and 1815

Privateers were privately owned vessels awarded a license by the government, and legally permitted—subject to certain restrictions—to sell seized ships and cargo to the highest bidder and keep any resulting profit. Privateering arose when Western European nations found themselves unable to maintain standing navies beyond a negligible size, or even any at all. When nations fought wars at sea, they found that the cheapest option available was to "hire" private ship owners for that purpose, by offering those owners all or part of the

[1]Corvisier (1979, p. 42) explains that recourse to professional war contractors was a "very convenient solution" to the problem of raising military forces and "was to be found everywhere in the fourteenth century." Later the private contractors were replaced by governments that "rented" their soldiers to other governments during times of war. For example, during the most important 18th century wars, a large proportion of Britain's armed force on land was actually composed of foreign troops placed under temporary British control, usually in exchange for a cash subsidy paid to their nation's ruler (see Brewer 1989, chap. 2). As late as the Crimean War (1854–56), Britain employed about 15,000 foreign mercenaries as contract combat soldiers (Bayley 1977, p. 115).

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value of any enemy ships and cargo they were able to capture (Pares 1938, p. 1). As navies grew stronger, nations continued to find employing privateers desirable. A primary objective of war at sea was and is the disruption and destruction of the enemies' maritime commerce. Historically that has been accomplished by blockading enemy ports and destroying enemy commerce on the high seas. Even as late as the wars of the French Revolution and the Napoleonic Wars, the British Navy—the strongest navy in the world—could not have maintained the blockade of France and her colonies without the help of privateers.[2]

Privateers provided a major portion of the ability of national navies to project power during wartime. Privateering was the most cost-effective means available to a belligerent government to wage war; obviously, the prizes that provided the necessary financial incentives for privateering were provided by foreign nationals. Also, the commissioning government might receive substantial net revenue from the activities of the privateers it licensed—assuming prizes were subject to tax, as was normally the case.

In several important wars during the period in question, privateering vessels far outnumbered the official "navies" of warring countries, and they probably contributed much more than warships to the actual harm done the enemy. During the Spanish War at the end of the 16th century, English privateers "far outnumbered the Queen's ships" (Andrews 1964, p. 21). Almost two centuries later, during the American Revolution, there were 800 vessels in commission in the "reserve naval force" (i.e., privateers) but only 198 vessels in commission in the Continental Navy (Stivers 1975, p. 29). Admittedly, those two cases were extreme. More typical of the overall record is the proportion of privateers to public navy efforts reflected in the manning of the vessels, as reported by the House of Commons for Britain during the Seven Years War (1756–63). In 1761, at the height of the struggle, 80,675 men were listed as "borne" by the Royal Navy; in the same year, 75,618 other men were crewing ships bearing letters of marque, that is, privateers (Neal 1977, p. 22).[3] Privateers were a large proportion of the total military force at sea during the 17th and 18th centuries.

Privateers were widely employed by warring governments because they were generally extremely effective in their appointed

[2]With the Act of Union in 1707, England and Scotland became united as "Great Britain." We will use the terms "English" and "British" to refer to the pre- and post-1707 eras, respectively.

[3]That number for letters of marque does not include the large numbers of similar letters issued, not by the British Admiralty, but by colonial authorities in America.

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task: damaging the ocean-going trade, including the military supply operations, of enemy nations. The damage inflicted on enemy merchantmen by privateers was sometimes huge. Between 1688 and 1697 England lost about 4,000 merchant ships to enemy (French) action, and most of those were seized by privateers. In the War of the Spanish Succession (1701–13), England lost 3,250 merchant ships, again mostly to privateers (Brewer 1989, p. 197).[4] However, English privateers were about equally successful through the 18th century as a whole.

Of course, privateering was usually profitable to the individual contractors and their crews, too. After all, it was a profit-maximizing business. Successful privateering cruises often netted the crews (and the ship's owners) handsome profits.[5] Even given the limitations of available profit rate data for much of the period of privateering, modern historians mostly agree that privateering in general was profitable during the Elizabethan period (Andrews 1964, pp. 128, 134, and 147). Moreover, privateering continued to be a profitable activity for many centuries (Stivers 1975, p. 66). The highly competitive nature of privateering, and not high costs associated with prize taking, constrained profitability.

In addition to providing the national government with the ability to hamper enemy commerce during wartime, privateering was a source of government revenue. The prize share claimed by the licensing government varied in different countries at different times from about 40 percent of the value of the prize to nothing—not counting the charges paid to the prize courts for adjudication, which were normally relatively small (totaling no more than 10 percent and usually substantially less).[6] Although the revenue from "prize taxes"

[4]Although better data are available for a longer period showing *British* losses, British privateers were also busy throughout that era causing comparable losses on the shipping fleets of other nations. During the War of the Austrian Succession (1739–48), Britain lost 3,238 merchant ships and France lost 3,434 merchantmen to the British (Bayley 1977, p. 198). Later in the Seven Years War, English privateers were relatively more successful than their French counterparts, taking 641 prizes; another 524 prizes were taken by His Majesty's ships (Neal 1977, p. 28). Swanson (1985, p. 377) shows that during King George's War (1739–48), British colonial privateers captured 829 prizes worth at least £7,561,000; during that war, approximately 36,000 Americans served aboard privateers at one time or another (Swanson 1985, p. 381).

[5]For example, during the Spanish War (1585–1603), the value of prize goods was equivalent to 10 to 15 percent of England's total imports; the average profit on fixed capital for 271 privateer voyages for the period 1589–91 was about 60 percent, although average economic profit is difficult to determine precisely and was probably somewhat lower (Andrews 1964).

[6]The "tax" ranged from two-fifths in the United States during the Revolutionary War to one-fifth in England before 1708, to one-tenth in Spain in 1718, to none in Britain after 1708 (see Stivers 1975, p. 117; Rogers [1712] 1928, especially p. ix; Shelvocke

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was never especially significant to the taxing governments relative to other sources of cash, it was almost pure net revenue given the very low cost to the government of providing the license. The government simply issued the license and allowed private enterprise to do the rest. The cost of the adjudication process was borne by the litigants (i.e., the privateers and sometimes the seized vessel's owner).

Owners of privateers (who typically did not sail with their vessels) employed a share agreement both in their contractual relationship with the captain and crew and in their relationship with the licensing government. The captains and crews of privateers were paid shares of the value of the captured prizes. That contractual arrangement was similar to the one used on whaling and fishing voyages; merchant sailors received a fixed monthly or lump-sum wage. As in whaling and fishing, shares were used on privateers because monitoring an individual's contribution to output was costly.[7] Activities that were relatively costly to monitor included standing lookout for potential prizes, fighting when confrontation with prizes turned hostile, and sailing prizes back to port as part of a prize crew. Typically, all crew members signed the privateer's Articles of Agreement, which precisely allocated shares in prize money to individuals holding various crew positions and a certain percentage to the owners (see Garitee 1977 and Stivers 1975 for representative examples).

Just as the owners of privateering vessels faced monitoring problems with captains and crews, the licensing government also faced monitoring problems with the privateers because commerce raiding was costly to monitor. If the costs of monitoring performance of privateers had been zero, the government could have simply paid privateer crews wages and appropriated privateering profits itself. However, the licensing government could not directly observe the behavior of the crews at sea (the inputs), and monitoring by the direct observation of output (number of enemy prizes seized) was impractical given the long time lags involved. The average English privateer brought in between two and three prizes per year (see Davis 1962, p. 333). Thus, it would have taken several years, by monitoring output, to determine if a privateer was shirking in its

[1726] 1971, p. xviii). The British Parliament enacted the Prize Act in 1708 that allowed privateers to keep the entire value of the condemned prize, although one-tenth was still allocated to the Admiralty Court (see Bourguignon 1977, p. 14). That "tax reduction" was aimed toward improving the incentives facing privateers and increasing the destructiveness of such private activity during wartime; evidently it did just that.

[7]See Alchian and Demsetz (1972) for a general discussion of the use of sharing contracts when contributions to output are costly to monitor.

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raiding duties or merely experiencing normal variations about the mean in capture rates.

High costs of monitoring inputs and outputs imply that a sharing arrangement would often be efficient. Share-owning employees act to maximize the value of their shares, thus "monitoring" themselves. That was precisely the contractual form used between owners of privateers and the state. Privateers were residual claimants to prize seizures, and the licensing government extracted some proportion of the residual in the form of tax. In fact, governments sometimes allowed privateers to keep the entire residual, minus a small percentage taken to defray the expenses of necessary adjudication (which will be addressed below).

Though the sharing contracts used in privateering solved one of the government's agency problems, they tended to exacerbate another—the problem of neutral rights. Granting privateer crews residual claimancy status provided them with an incentive to seize prizes even when ships were engaging in legal commerce. National governments generally appear to have judged that the problem was handled adequately by the prize-court process, which is described below.

To the extent that privateering operated as a militarily efficient means of projecting national power (i.e., damaging an enemy nation), it reduced the demand for a standing national navy, for which it was a substitute. That was in spite of the fact that privateers were usually careful to avoid actual combat if at all possible.[8] Their goal was to seize the richest cargo at the lowest cost.

Privateers played no important role in strategically significant battles at sea. Admittedly, there were important operational and practical differences between the private and the public "navies." By the 17th century the national navies performed certain specialized tasks that privateers could not or would not perform. For example, privateers could not blockade an enemy port without the support of the navy if the enemy maintained naval warships in the port or vicinity, for even the weakest warship outgunned a privateer, and privateers would engage those ships only if they had no other alternative. If, however, a privateer did capture an enemy warship, it could claim the warship as a prize, usually selling the captured ship to its own or some other nation's navy. Privateers were less useful in convoying merchant ships because escorts of merchantmen very rarely captured

[8]At one extreme, American privateers carefully avoided tangling with men-of-war, and many actually were "armed" with dummy, wooden "guns"—their aim was to overawe potential prizes, not actually to fight (Stivers 1975, p. 97). Although many privateers were quite heavily armed with real guns (see Rogers [1712] 1928, p. x), the intention was usually to frighten their victims, not to engage in combat.

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prizes and because escorts had to be prepared to fight, which in general privateers were not. For similar reasons, privately owned and operated vessels rarely served as cruisers, which protected merchant shipping by hunting down enemy commerce raiders.[9]

In overall strategic effect, the operations of privateers were analogous to 20th century submarine campaigns against the sea lanes of communication to enemy countries, which proved highly effective in both world wars (see Powley 1972, p. 192, for a similar argument). Naturally, the technology and detailed operational techniques were radically different, but the strategic result was similar. On some occasions the operations of privateers effectively crippled the seaborne trade of major powers and led to severe impacts on those countries' domestic economies—and indirectly led to victories for the governments who provided the privateering "franchises." Privateering was also less wasteful of resources than submarine campaigns, for the simple reason that the former aimed at seizing and reselling the target ships and cargo, while the latter just sank them. Ships, cargo, and crew at the bottom of the sea were lost to the world economy.

Law without Legislation: The International Law of Prize

While both privateers and pirates shared similar goals—stopping and seizing merchantmen on the high seas—there were critical differences between the two groups. Pirates were criminals, and piracy was a capital offense. In contrast, privateers had a commission from some recognized legal authority, either a monarch, a congress, or a parliament. That license gave the privateer the legal right to stop, board, search, and under some circumstances seize foreign vessels and their cargo. Privateers were obligated to then promptly present those "prizes" to a specialized court, which normally sat in the privateer's home port, for adjudication. The precise requirements for a legal seizure were highly detailed and rigidly enforced. Assuming

[9]However, "[i]f the privateers could not be expected to fight uncalled-for battles against the enemy's ships of force, at least it was hoped they would support the trade of their country by recapturing a certain number of merchant ships from the enemy" (Pares 1938, p. 29). To encourage that endeavor, the English paid privateers "salvage" for recaptured merchant vessels. An act of the English Parliament in 1693, for example, set the salvage rate at one-eighth the value of the vessel and cargo if the vessel was recaptured within 24 hours of its capture, rising to one-half the value if the vessel had been in the hands of the enemy for more than 96 hours. French law at the time specified that a privateer was entitled to claim the entire vessel as a prize if it had been in enemy hands for at least 24 hours (Pares 1938, p. 30).

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that the prize was found in court to be indeed lawful, proceeds from its sale (and the sale of its cargo) at auction were distributed to the privateer—and sometimes a significant portion was extracted by the government. While those arrangements differed in some details over time and across countries, there gradually arose a body of international law based on a common set of basic precedents that was employed by prize courts in different countries. Moreover, the commissioning governments usually imposed additional strict rules on privateering. Those rules were designed to prevent criminal actions (including violations of the rights of neutral parties) by private "contractors."

From the standpoint of the responsible governments, there were a number of potentially serious problems that might arise from the licensing of privateers. Privateers might despoil friendly vessels, endangering the lives and property of fellow citizens; delay, seize, or otherwise damage the vessels belonging to the citizens of neutral nations; or violate the rules of war in other ways, such as throwing overboard the crews of captured vessels. The most complex and difficult problems arose in relation to the rights of neutral states to engage in trade during war.

Throughout history, states have often found that it is in their interest to respect the rights of neutrals who traded with their enemies. For one thing, the warring state was often itself trading with that particular neutral. Even when that was not the case, a currently warring government could normally expect to be a neutral state in some future conflict, in which it might well benefit from claiming neutral rights. Preserving the legal precedent for respect of neutral rights by belligerents was, therefore, protecting a valuable resource.

Another constraint on the behavior of belligerent powers was the risk that a neutral state would go to war to protect the rights of its citizens or the interests of its rulers, or both. Numerous examples exist of cases where even the hostility of a relatively weak country has presented a significant problem to a strong country already at war. Great Britain, for example, treated the complaints by the government of the neutral Dutch Republic during the Seven Years War quite carefully and made a serious effort to keep the Dutch from entering the war on the side of France. Efforts by the British government to protect the rights of neutral Spain were even more concerted, and Britain "made the most of every excuse by which they could consistently acquit Spanish neutrals in the Seven Years War." That was because Britain "was more afraid of Spain than of the Dutch Republic, and had gone farther to buy her neutrality by concession"

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(Pares 1938, pp. 202–3). Though the laws of war were a constraining influence at the margin, it was still true that "might made right."

In the context of the delicate balance of power in 16th- to 18th-century Europe, in which patterns of alliance frequently shifted, there were particularly strong reasons to respect neutral rights. Today's neutral nation could (and often does) become tomorrow's enemy, or ally, and the neutral nation's choice might be significantly influenced by the treatment its commerce has received at the hands of the opposing belligerents. Shifts in coalitions were highly unpredictable. Between 1672 and 1674, England and Holland were at war with each other during the Third Anglo-Dutch War. But by 1688, England and Holland were allied together against France in the War of the League of Augsburg (1688–97). Again, in 1701, England and Holland were allies at war with France and Spain in the War of the Spanish Succession (1701–13). But in 1718, England and France were allied in war *against* Spain in the War of the Quadruple Alliance, in which British navy vessels actually transported French soldiers on several occasions. That war occurred during a 15-year period of alliance between England and France—countries that spent much of the rest of the 18th century almost continuously at war with one another. When at war, standard strategy dictated that neutrals be nudged toward becoming active allies and allies of the enemy be convinced of the advantages to be gleaned from becoming more neutral.[10]

A system of adjudication of prize cases and of the claims of neutral status was required to efficiently resolve the many disputes that were likely to arise. In fact, such a system of international adjudication developed to the point where, by the mid-18th century, it represented a complex and generally effective legal order.

Law is the body of enforced rules of conduct. Legislation is the deliberate construction of a set of rules of conduct by an identifiable governmental agency. The international law of prize, which evolved in Europe and North America after about 1500 was the result of voluntary acceptance of legal precedent and principles of arbitration,

[10]One device that proved helpful in providing an incentive for private men-of-war to avoid diplomatic problems with neutral states was the requirement to post a bond before sailing. Misbehavior could then be readily penalized by the licensing government. As early as the reign of Edward VI, in 1547, English private men-of-war were required to give security for "good behavior" before they left port (Marsden 1909, p. 685). That practice became general. The bond could be, and frequently was, claimed by the government when the privateer was found to have violated stated conditions of his license. However, an orderly process for adjudication was still necessary for efficiently determining the actual fines imposed. The Admiralty Court determined the size of the fine.

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although influenced at the margin by the terms of treaties occasionally made between governments. In short, the international law of prize had major elements of what F. A. Hayek calls "spontaneous order" (see Hayek 1973, pp. 72ff).

The laws of war governing conflicts in Europe and the Americas during the period in question arose from custom and precedent, by treaties between nations, and from time to time a unilateral declaration of policy by a militarily strong belligerent nation (Roberts and Guelff 1982, p. 2). The principal aim of those laws was to specify the rights and obligations of belligerents and the rights of neutrals. The laws recognized the right of a state to remain neutral during war. Further, neutrals had rights to continue maritime trade during times of war, including the right to trade with the belligerents subject to certain restrictions. It was in relation to neutral shipping that privateers generated the most diplomatic conflict.

Like all other legal rules, the laws of war by no means performed their function perfectly. Individual nations sometimes chafed under the international rules. A particularly vexatious problem involved the legal right of neutrals to engage in trade with an enemy country. Various treaties between the maritime powers of Europe in the 17th and early 18th centuries had introduced the doctrine of "free ships, free goods." That meant that neutral ships could trade with a belligerent as long as trade did not include goods on the contraband list and was not conducted through blockaded ports. This international rule implied that all cargo on neutral vessels was presumed neutral. The rule itself was simple, but the exact *interpretation* was frequently disputed. One especially significant reinterpretation was initiated by the British government during the Seven Years War (1756–63). As a result of the success of the British Navy and privateers against French merchant shipping, the colonial trade of France was soon contracted out to Dutch (i.e., neutral flag) ships. Although the legal issues involved were complex, in essence the British government decided that Dutch trade conferred too great an advantage on the French (and incidentally the Dutch as well) and unilaterally declared that trade subject to seizure.[11] Still, despite occasional unilateral

[11]Further, ambiguities in the British government's policy and the exuberance of the privateers resulted in illegal prizes even by the standards of the reinterpreted rule. Some of the Dutch grievance was the result of the change in policy on the part of the British government rather than a result of illegal acts (under the new rules) on the part of privateers. When British privateers began capturing Dutch ships engaged in this trade with the French, the Dutch government protested. Many Dutch claimants secured release of those vessels when they were taken illegally, although even in these cases many owners were not awarded compensation for their costs in time and money, which were sometimes substantial. If, however, the captor was deemed sufficiently irresponsible, the court awarded the claimant damages in addition to ordering the

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policy shifts of that sort, the basic outlines of the international law of prize remained stable for a long period.

If the laws of war had no power to constrain the behavior of belligerents and their agents, then clearly privateers could easily become no better than pirates. In fact, the laws of war did have a moderating influence on belligerents' behavior. As with all laws, changes in external circumstances (as occurred during the Seven Years War) led to changes in the form of the optimal structure of rules. The international law of war at sea was continually modified as treaties were enacted and as the body of legal precedent developed.[12]

Until this century, there existed no international organizations with the coercive power to enforce obedience to any set of international rules, nor any international agency or tribunal that legislated the rules themselves. Yet a system of international law based on the self-interests of the various, competing national governments evolved anyway. As one source (Roberts and Guelff 1982, p. 15) observes:

> Critics may argue that states involved in conflicts will always put their vital interests first, and the law will be violated if it clashes with those interests. But in fact the position is not nearly so simple. The law has been created by states with their general interests [in mind]. Thus it is not an abstract and external imposition on the international system, but rather a direct outgrowth of it.

Privateering, therefore, was a "legitimate" business that operated within a carefully defined, actively enforced framework of law.

Prize Courts and Prize Law as Controls on Malfeasance

By the early 18th century, a body of international legal principles and precedents had emerged that carefully delimited the rights associated with prize taking during wartime, as well as the rights of neutral vessels. That body of law was enforced by a system of prize

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return of the ship and cargo (see Pares 1938).

[12]During the heyday of prize taking, new bilateral treaties were extremely frequent in Europe; one recent source lists 227 different treaties between England (Great Britain) and other countries made between 1688 and 1761 (Cook and Stevenson 1988, pp. 132–44). Hence, the accepted ground rules for prize taking were almost constantly being renegotiated between governments. Pares (1938) offers a detailed analysis of the significant changes in the international rules for conduct at sea during the Seven Years War (1756–63). The changes adopted by the English in the Seven Years War were part of a long line of such amendments made in response to changes in circumstances, including advances in technology. Those responses to change continued down through and including the world wars of this century.

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(or admiralty) courts established in each seafaring nation. Although the different court systems varied in terms of procedures and organization, the application of the international law of prize was quite uniform. One pair of authorities (Jessup and Deak 1976, p. 247) has succinctly summarized the significance of the often-neglected situation:

> One of the most usual criticisms of international law is that it lacks judicial machinery for its application and enforcement. Here is an ancient body of law constantly applied by courts. The courts were indeed national in origin and organization, but they lived up fairly well to the tradition that they applied international law.

Privateers were legally obligated by their commissioning governments to follow established prize court procedure. They were required to bring all seized goods before an established prize court in their home port and prohibited from alienating (i.e., appropriating) any goods on a captured vessel before those goods had been condemned by the court. Condemnation meant the court had decided that the seized vessel, or goods, or both were legitimate prize. Only after that could the privateer legally sell the prize, usually at auction. In the event that the prize court found for the defendant (i.e., the owner of the seized goods), the captor was liable for restitution and damages to the owner (Jessup and Deak 1976, p. 207). The privateer had a strong incentive to follow the rules and bring the prize before the court to be legally condemned. That gave the privateer legal title, without which the prize would have been salable only at a discount,[13] and the privateer legally defined as a pirate—a crime punishable by death.

Adjudicating cases involving enemy vessels carrying enemy goods was fairly simple—an enemy ship was almost always condemned by the court as a "good prize" (Jessup and Deak 1976, pp. 124, 217). Enemy vessels carrying cargoes owned by neutrals and not destined for an enemy port were a more difficult problem; generally, if the neutrality of the cargo could be proven (and assuming that it was not composed of contraband), it would be returned to its rightful owner.

[13]By the 17th century, it was generally conceded that a prize judgment followed by a prize court sale "gave good title against the world" (Jessup and Deak 1976, p. 209). Furthermore, it was in the interest of belligerent governments to listen to complaints from neutral claimants about purported irregularities. The refusal of the courts of one nation to recognize the title conveyed by a prize court of another nation would hinder the sale of future prizes condemned by the former nation's court (Jessup and Deak 1976, p. 209). Failure to strictly observe the legal formalities in the proceedings was often the basis for a condemnation's reversal and a compensation award to the original owners of the seized vessel.

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Neutral vessels constituted the most serious practical problem; enemy ships could only rarely prove that they carried neutral cargo. In the case of a neutral ship its cargo could be subject to condemnation if the cargo was destined for a belligerent port when a blockade was in force and included contraband of war (Jessup and Deak 1976, pp. 124, 217).

A seized enemy vessel carrying cargo for neutral owners, or a neutral vessel carrying contraband, was potentially a "good prize" only if its destination was proven to be a blockaded port. That meant the port in question was actively patrolled by the naval forces of the hostile power who actively attempted to board and inspect outgoing vessels and stop incoming vessels from arriving (just declaring a port to be blockaded was not legally sufficient). Contraband of war was at first defined to include a small array of goods that were clearly of direct usefulness to the enemy war effort (e.g., gunpowder, cannon, and naval stores), but over time the list tended to become more inclusive. Lists of contraband items were often included in treaties with neutral countries, and the definition of what was and what was not contraband was normally understood by all relevant parties before hostilities began (Jessup and Deak 1976, p. 62). Those same scholars note (1976, p. 103) that violation of the law of contraband "resulted frequently in compensatory awards by the violator." Technically, a neutral vessel could carry noncontraband cargo to a blockaded port, or carry contraband cargo to a nonblockaded port, and its owner's property would be protected by the prize court.

If the owners and officers of a seized neutral vessel could demonstrate that its papers were in order and could provide satisfactory answers to the standard interrogatories required by the prize court, the ship would routinely be released by the court.[14] In such cases, the captor was often required to pay the costs of the trial and to compensate the owner for damage resulting from the illegal seizure. Seizing a prize without being able to demonstrate "probable cause" could impose significant costs on the privateer (Jessup and Deak 1976, p. 224). Prize courts also routinely released vessels seized in

[14]Those papers included such documents as registers, invoices, bills of lading, and proof of identity and ownership. It was standard prize court doctrine that the prize's fate was to be determined "out of her own mouth" (on the basis of the papers found aboard). A standard presumption was that the absence, concealment, or destruction of the ship's papers, or the presence of fraudulent papers, was sufficient grounds for condemnation of the prize, which was reasonable given the strong incentives for misrepresentation on the part of neutral merchantmen during wartime (see Jessup and Deak 1976, pp. 230–38).

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violation of international treaties, even if the vessel in question would otherwise be a "good" prize (Jessup and Deak 1976, p. 79).

Despite the obvious potential for abuse (e.g., English prize courts adjudicating disputes involving the prizes seized by English privateers), the basic principles of prize law were accepted internationally, and prize court decisions were generally respected. There were various appeals available in cases where a neutral owner challenged a prize court decision. There were numerous examples of prizes being returned to their rightful owners as the result of successful legal defense.[15]

The laws of war and in particular the prize laws and courts of the various states did a reasonably good job of protecting neutral rights. Many of the grievances of neutrals were the result of changes in policy by belligerent states rather than violations by the privateers themselves. The policy changes, responses to changes in external circumstances, resulted in temporary problems as affected parties adjusted to the new rules; once that occurred, the system once again worked well at protecting neutral rights under the new regime.

It should also be pointed out that the alternative to using privateers, employing commissioned naval vessels with commissioned naval officers as commerce raiders, would have generated the same kind of problems. Use of commissioned ships would not have reduced the complaints of neutrals that resulted from policy changes on the part of belligerent governments.[16]

Costs and Benefits of Legalized Theft on the High Seas

Privateers were private contractors, privateering was a highly competitive industry, and complex international legal institutions for adjudicating prizes served to minimize many potential problems. However, privateering was fundamentally different from other kinds of "service" industries; privateering represented a form of legalized theft of private property.

[15]While privateering has been abolished by all world governments, as has the award of prize money to naval personnel, it is interesting to note that basic elements of the international law of prize and contraband remain essentially unchanged. See De Lupis (1987, pp. 305–12) for a summary of the modern status of captured prizes in international law.

[16]For example, the North used only commissioned naval vessels to take prizes during the Civil War. Yet many complaints arose alleging the illegal taking of prizes; in fact, that issue could easily have brought Britain into the war on the side of the South. See Bernath (1970) for a detailed discussion of the Civil War prize cases.

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During the late 19th century, many opponents of privateering argued that the fundamental violation of the inviolability of private property on the high seas was an intolerable abuse of human rights.[17] Regardless of the sincerity of those protests, it is indisputable that the efficiency of the global economy, other things held equal, would have been increased if private property rights at sea had been protected from theft.

Actual events have demonstrated that other things were *not* equal. As the history of the past century has demonstrated, during wartime the real alternative to the seizure of merchantmen destined for belligerent ports was not the protection of private property rights during war but the *destruction* of enemy commerce. Prize taking stopped, but only to be replaced by the wholesale sinking of merchant vessels.

The net effect of privateering on the economic costs of war is more difficult to assess. Arguably, privateering was cheaper from the perspective of the commissioning government's budgetary requirements. Privateers were "financed" by the enemy. By lowering the cost of projecting naval power, privateering may have encouraged governments to engage in war more often than they otherwise would have.[18] On the other hand, to the extent that privateering was an effective means for damaging the enemy economy and war effort, it may have tended to bring wars to a quicker, and less destructive, end.[19]

Further and perhaps more important, since privateers were volunteers, the resources they used were not being drawn from higher-valued nonmilitary uses. In contrast, contemporary navies all

[17]The Pierce administration's Secretary of State, W. L. Marcy, repeatedly reiterated that the failure of the Declaration of Paris to explicitly protect *all* private property rights at sea, regardless of the identity of the potential captor, was his major objection to the declaration (see Stark 1967, p. 149). That position incidentally implied that Secretary Marcy opposed the traditional presumption that seizure of enemy-owned goods was in principle legal and proper.

[18]According to Baugh (1965, p. 22) there is some evidence that privateers actively lobbied the British Parliament for war with Spain in the late 1730s in order to increase profit opportunities on the high seas. At various times, potential privateers may have lobbied for war in pursuit of profit, but not even historians who are most biased against privateering argue that such lobbying was politically significant.

[19]There is another reason why the availability of privateering may have reduced the incidence of war. The potential availability of private men-of-war to smaller nations, and those with relatively weak standing navies, represented a deterrent against aggression by larger, better-armed powers. Privateering allowed smaller nations, with weaker navies, a better chance to seriously damage larger nations with bigger navies. Thus, the availability of privateering helped to protect smaller states from the imperialistic designs of the larger and more powerful nations, reduced the potential "profits" from aggressive war, and possibly limited the frequency of conflict.

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resorted to the use of impressment of seamen during wartime, sometimes on a wide scale (Rodger 1986).

Although it would presumably have been feasible for governments to grant their own national navies monopoly rights in prize-taking activities, no major nation did so until after 1856. However, that appears paradoxical, at least on the surface. If the national navy had been granted monopoly rights, the government could have claimed a share of the resulting prize money. In fact, the government often *did* claim a portion of the value of prizes seized by naval vessels (as is explained below). Why did revenue-maximizing governments *not* simply nationalize prize taking?

The relatively greater efficiency of privateers as prize-taking "firms" helps to explain why public navies were not granted monopoly rights in prize taking. Privateers were a lower-cost method of attacking enemy commerce, and they also produced more net revenue for the licensing government than a grant of monopoly prize-taking rights to the public navy would have provided.

The generally superior efficiency of private production compared to public production of public goods has often been noted. But privateers also had another advantage over national navies as suppliers of "commerce-raiding services" during wartime. The transactions costs associated with such activities were lower for privateers. Since commerce raiding had value to the belligerent government only in time of war, in peacetime the official navy would have to bear the cost of storing or selling the vessels used for commerce raiding, as well as the cost of supporting commissioned officers (in England, often at half pay). Owners of privateers would simply use the vessels as merchant ships in peacetime and convert them for privateering in time of war. In peacetime most navy vessels were a drain on government resources because of the high cost of maintaining them; in peacetime, most of the fleet was laid up in reserve ("in ordinary," to use Royal Navy parlance). For example, in September 1739 only 89 of the total 170 British warships were actually in service; the rest were in various states of storage (Baugh 1965, p. 246).[20]

Building and maintaining naval vessels was expensive, and governments intentionally allocated scarce financial resources to providing themselves with these kinds of ships that had no private-sector equivalents (e.g., large ships of the line, which were powerful but too slow and unwieldy to serve as merchantmen) and relied on the

[20]Moreover, the smaller vessels, which were equivalent to privateers in size, speed, and number of cannon, were mostly sold off between wars, as they were expensive to store but had a ready market as potential merchant vessels (Baugh 1965, p. 254).

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private sector for other ships.[21] Even nations with strong navies hired merchant ships in large numbers during time of war over and above the numbers of licensed privateers.[22] Over time, increased specialization of both merchant and large naval vessels ruled out the use of hired vessels as ships of the line, but there was still a role for hired merchant ships as cruisers (which hunted down enemy commerce raiders) and for convoy escorts.[23]

However, technological and other changes since the American Civil War have tended to reduce or eliminate some of the differential costs between privateers and navy ships. As warships have become more specialized (e.g., the submarine), they essentially have no peacetime use, thus eliminating the transactions cost advantage enjoyed by the private sector. Radio, undersea cable, and telegraph increased the ability of navies to communicate with their ships at sea and in port, thus reducing the costs of monitoring their activities and weakening the contractual advantage of the private sector.[24] By greatly increasing the cost of seizing prizes at sea, technological change reduced the viability of sharing contracts between governments and private providers of defense.

But before those technological developments occurred, contemporary governments experimented with granting their national navies the right to seize commerce in wartime. One of the lesser-known features of naval warfare between the turn of the 16th and the end of the 19th centuries was that public navy vessels and their crews

[21]The Royal Navy even had to build the larger warships in its own dockyards, as the private shipbuilders lacked the specialized facilities and skills the big ships required. However, the British Navy routinely contracted with private shipyards for the construction of medium-to-small vessels armed with 50 or fewer guns (see Baugh 1965, p. 255).

[22]Such was the case in Great Britain, where "during the wars of the seventeenth century, the line of battle fleet was heavily supplemented by larger [armed] merchant vessels" (Davis 1962, p. 330).

[23]The government also hired large numbers of "victuallers, water carriers, fire ships and hospital ships; [as well as] fleets . . . for the transport of troops overseas" (Davis 1962, p. 330). Since those ships had little or (more usually) no chance of capturing prizes, the government paid their owners a monthly rate based on size (i.e., measured tons). Owners of ships hired as warships not only received higher rates than owners of those ships used in noncombatant roles, they also received compensation for war damage or loss. Those whose ships were used in noncombatant roles as victuallers, transports, and in various other support tasks, did not receive such compensation, but they "ran few risks, being usually employed under heavy escort" (Davis 1962, p. 331).

[24]Further, the existence of ship-to-shore radio, air support, fast surface ships, modern gunnery, the submarine, and, in World War II, radar significantly increased the cost of sending prizes to a friendly port where they could be sold. Since the Civil War, commerce raiding has been devoted almost exclusively to the sinking of enemy merchant vessels.

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were permitted to seize prizes and claim the proceeds.[25] According to one historian who has studied the internal workings of the Royal Navy in the 18th century, prize money during wartime was the "chief attraction of Naval service" (Baugh 1964, p. 112).[26] Furthermore, the prize revenues could be enormous.[27] Other navies of the time also permitted, and in fact encouraged, prize taking.[28]

Governments discovered that, as a rule, naval warships were less efficient than privateers as raiders of enemy commerce. One problem was that many warships were simply too slow and difficult to maneuver to chase merchantmen with any realistic hope of success. Technical constraints applied to pre-steam naval construction; a heavily armed ship needed to be big and heavy if it were to be a stable gun platform, but with greater size came a loss in speed and agility. A large, "first-rate" man-of-war might carry over 100 cannon but could

[25]Permission to claim prize money was first granted to the English Navy by Cromwell in 1649 (see Dupuy 1977, p. 555).

[26]Shares in returns from the sale of seized prizes were standardized. For instance, in Britain in 1740 one-eighth was allocated to the flag (i.e., the Commodore or Admiral commanding the fleet in which the captor was included), one-fourth to the ship's captain, three-eighths to the other officers, and one-quarter to the crew (Baugh 1965, pp. 112–13, n. 72). Similar distribution schedules were operated by the navies of other nations.

[27]One battle (Cape Ortegal, against a French fleet) brought two British admirals in command of a victorious fleet £62,991 and £31,496, respectively; that single battle brought a total of £755,896 to the various participants (Gwyn 1973, pp. xlii–xliii). The period of war between 1739 and 1748 earned British Admiral Warren over £127,000 in total prize money (Gwyn 1973, p. xliv). Of course, the average crewman received a much smaller average share, although at least one authority (Rodger 1986, p. 129) argues that the average prize share a British Navy sailor serving on board a small, fast ship could expect to receive was similar to what the average crewman on board a privateer could expect. Unfortunately for the Navy, the expected prize share for sailors serving on board the extremely manpower-intensive, large warships was likely to be zero, because such vessels had almost no chance of capturing valuable prizes. The Royal Navy relied on impressment to man the large ships during war.

[28]Interestingly, John Paul Jones—famous as the founder of the U.S. Navy, Revolutionary War hero, and celebrated for his various naval exploits—is less frequently remembered for his remarkably successful record of prize taking. Between 1778 and 1781 most of Jones' prizes were sent to ports in France, Holland, and Denmark to be adjudicated and sold. Complete accounts do not seem to have survived, but, after 1783, the French government settled a dispute with Jones by giving him 181,000 livres representing the value of his prizes sold by French courts (Buell 1900, vol. 2, p. 103). Consequently he was able to retire from the U.S. Navy as a wealthy man. Jones, incidentally, repeatedly expressed contempt for greedy private prize seekers, whom he described as "maggots" infected with a "mercenary spirit," and insisted that he himself was above such avarice (Russell 1930, pp. 69–70, 121). That was the same Jones who vigorously, and successfully, lobbied the Continental Congress to lower the tax rate on prizes seized by the navy to encourage public prize takers in competition with the allegedly "parasitic" privateers (Lorenz 1943, pp. 87–88).

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sustain a speed of only around two knots (about 2.5 miles per hour). Privateers were normally smaller ships that could sustain speeds in excess of 12 knots under ideal conditions.

But that was not the only reason for the relatively poor performance of navy vessels as commerce raiders. After all, before 1750, about two-thirds of the British fleet was composed of ships in the fourth-rate class and smaller (Brewer 1989, p. 34). Privateers were in the same approximate size range.

Unlike privateers navy vessels were not optimized for commerce raiding; they had numerous other duties. Most important, navy warships were designed to battle enemy warships and thus required much heavier armament. Warships were much more effective than privateer ships against enemy warships—that is unsurprising considering that such encounters were intentionally avoided by privateers. For example, during the Seven Years War, the Royal Navy took or destroyed 328 French naval vessels while British privateers accounted for only 48—and those probably occurred because occasionally actual battle was unavoidable (Neal 1977, p. 29).

In other words, even though public warships were encouraged to take prizes, for a variety of reasons they were less efficient in that particular endeavor than private, licensed contractors. Moreover, permitting private ships to legally compete with naval vessels for the same potential prizes reduced the size of the prize shares available to navy vessels.

Political Economy of the Demise of Privateering

We have argued that privateering provided a major portion of the naval power employed by national governments for several centuries, that it appears to have been a highly potent device for harming an enemy, and that a complex set of international legal institutions evolved that served to minimize the worst abuses and protect the rights of neutral vessels. In short, privateering seems to have been a fairly efficient system for providing war-fighting services to governments at low cost. Nevertheless, privateering was virtually universally abandoned by national governments after the mid-19th century. That surprising rejection deserves more attention than it has hitherto received.

Did improvements in the technology of naval warfare render privateering obsolete? After the American Civil War, naval warfare underwent a technological revolution in which wooden sailing vessels armed with inaccurate, short-range, muzzle-loaded cannon were replaced by faster, heavily armored warships equipped with more

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accurate, longer-range, and much more lethal breech-loading rifles. Also came the advent of the submarine, at least in a militarily efficient form, with the capability to annihilate merchantmen with virtually no warning—and with no capacity for prisoners or room to carry prize crews. Modern gunnery allowed merchant vessels to cheaply and effectively protect themselves and place potential prize takers at serious jeopardy.

While altered technological constraints were surely significant, it is simply a fact that technological advances played absolutely no immediate, direct role in the demise of privateering. We can assert that with confidence because privateering essentially ended before the American Civil War (although the Confederacy issued letters of marque for a brief period).[29] The major changes in naval technology all occurred later.

Rhetoric concerning the purported evils of privateering was partly a result of diplomatic problems caused by privateers over the rights of neutrals and partly the public face of opposition from national navy bureaucracies, who correctly perceived privateers as close competitors as the suppliers of naval force to governments. Public navy officers and other officials fought a running battle against the commissioning of privateers for centuries, sometimes with temporary success.[30] When the national standing navies could not prevent the commissioning of privateers, the navies went to great lengths to harass their private competitors and to generally restrict their ability to compete.[31]

Consequently, the national navies had a twofold incentive to oppose the licensing of privateers: the potential loss of wartime prize

[29]The Confederate States of America issued a small number of letters of marque until April 18, 1863, when the Confederate government eliminated all privateers within its jurisdiction and replaced them with navy vessels (Robinson 1928, pp. 327–29).

[30]For example, during the War of the Grand Alliance against France (1688–97), the English Admiralty granted only a few privateering commissions and actually ceased issuing commissions altogether in 1695 (Ritchie 1986, pp. 42–43). The stated reason for the cessation was to ease the manpower shortage facing the Royal fleet (Clark 1971, p. 50). However, it is clear that the Royal Navy was also concerned about the loss of potential prize money to letters of marque, which was the subject of frequent complaint by naval officers (Clark 1971, p. 59). Only political pressure exerted by the powerful East India Company along with other merchants caused the Admiralty to issue new commissions (Ritchie 1986, p. 43).

[31]Privateer vessels were often literally robbed of their crew via impressment by the navy while they were at sea. Naval commanders preferred sailors with experience as private "warriors" over those with more pacific resumes. During the War of the Grand Alliance and on many other occasions, the Royal Navy did what it could to reduce, if not completely stop, the issuance of privateering commissions (Ritchie 1986, pp. 42–43), in part, to eliminate competition for skilled sailors.

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money and the loss of budgetary resources from the government. On a number of occasions, politicians took explicit note of the relative efficiency of privateers, to the potential detriment of career naval officers. A particularly notable example occurred after the American Revolution, when many in Congress opposed the maintenance of a regular navy because private enterprise had shown that it could do a better job, at low cost to the government (Stivers 1975, p. 55).

The bureaucratic "turf battle" finally ended after privateers were prohibited by international treaty. In 1856, most of the maritime powers signed or acceded to the Declaration of Paris, which formally abolished the taking of prizes at sea by privately owned vessels (Israel 1967, p. 957).[32] The United States refused to ratify the declaration, stating that as written it did not go far enough to protect private property rights at sea and that the United States might have need of privateers in future wars, as it had in the past.[33] Despite those stated objections to the declaration, the United States has not, in fact, commissioned any private men-of-war since that time. In 1899, during the Spanish-American War, the United States formally abolished privateering and further abolished the award of prize proceeds to the navy (Robinson 1928, p. 344). One authority on privateering summarizes those developments by commenting that "after 1815 [the navy] would properly see to it that never again would a reserve naval force [i.e., privateers] be as predominant as the privateersmen had been" (Stivers 1975, p. 134).

[32]The Declaration of Paris immediately followed the Crimean War. That conflict led the strong naval powers of France and England to conclude that privateering was an effective weapon of weak naval powers and, thus, that the abolition of privateering was in their interest. Even a small, neutral state that could not afford a standing navy might license privateers in time of war, and in the case of a state engaged in little overseas trade, the relative advantage in privateering would often be with small weak neutrals. In the words of one authority, by "taking a stand against privateering, they hoped to serve their own cause—and quite incidentally that of the neutrals—by abolishing it" (Jessup, writing in Turlington 1976, p. v). According to that view, privateering was eliminated not because it was inefficient but because it was believed to be an effective tool in the hands of weak maritime powers. That line of explanation is consistent with the argument above concerning the role of the naval bureaucracies—which were naturally the largest and the most powerful in countries with relatively strong navies.

[33]The declaration implicitly allowed for the continued taking of prizes at sea by naval vessels and, therefore, failed to really provide protection for private property rights at sea (see Stark 1967, pp. 143–48 for details). The U.S. Secretary of State made it clear that his country "could never acquiesce in any change of international law which might render it necessary to maintain a powerful navy or large standing army in time of peace" (Savage 1969, p. 78). As written, the Declaration of Paris merely granted government navies the monopoly right to take prizes at sea. The United States also made pointed reference to the "coincidence" that the country with the strongest interest in abolishing privateering, Great Britain, just happened to have the strongest standing navy by far.

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Conclusion

Privateering appears to have been profitable, and it represented a means of projecting national force during wartime that was cheap to the sponsoring governments—indeed, it sometimes generated net revenue to the licensing governments. It was also less wasteful than other forms of naval "combat" because it did not destroy, but merely reassigned ownership rights to, property. Privateers sought to damage their prizes as little as possible so as to protect their resale value. Yet for all those seeming advantages, privateering gradually ceased to exist.

The extinction of privateering was at least partly the result of rent seeking by established government bureaucracies. National naval bureaucracies recognized privateers as competitors who threatened their mission and budgets, and the bureaucrats often vented their hostility. That was a rational, albeit self-interested, response on the part of the professional navies. But the result was the legal abolition of privateering. Privateering was not a market that can be shown to have "failed"; rather it was one that was eliminated through political means.

The record of the private provision of naval power belongs alongside Coase's lighthouses as an example of the successful provision of a public good—in this case, national defense—by private enterprise. The private provision of naval power was proven feasible by its long history of use. It was apparently efficient from the perspective of licensing governments. The question of the efficiency of privateering from the standpoint of the global economy is more difficult to answer. However, the government monopoly naval force that replaced privateering almost surely has had a still more detrimental impact on the world economy.

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Foreign Profits and the Political Economy of Quotas

Paul E. Godek

> Tariffs are the weak, quantitative restrictions, the strong form of government interference with international trade.
>
> —Jan Tumlir (1985)

Introduction

Trade restrictions subsidize domestic producers. Foreign producers, along with consumers and allocative efficiency, are traditionally viewed as losers in the process of redistribution through trade restrictions. The increasing use of quantity restrictions, however, has induced students of trade policy to re-examine part of the traditional approach. New protectionist measures often take the form of discriminatory quotas—quotas allocated to individual foreign producers.[1] Such quotas can make foreign producers beneficiaries of protectionism by giving them a property right similar in value to the forgone revenue of the equivalent tariff. Here, I examine the simple relationship between quotas and the profits of foreign producers in order to demonstrate the surprising range over which a quota can raise foreign

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[1]Nontariff barriers of some sort cover between 30 percent and 50 percent of world trade by some estimates. See Tumlir (1985) for a summary of studies examining the growth of nontariff trade restrictions, as well as for an incisive study of the political and legal history of protectionism. The U.S. experience is well documented by Bergsten et al. (1987). They estimate that 18.3 percent of U.S. imports were covered by quantitative restraints in 1986, up from 5.1 percent in 1980. When quotas are instituted and allocated by the exporting country, they are often referred to as voluntary export restraints.

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producers' profits above free-trade levels.[2] The results reveal one of the political functions served by quotas and may help explain their increasing use.

Quotas and Profits

In general, quotas are assigned, not auctioned off. They may be granted directly to foreign producers or to individual countries, which then allocate them to producers. In either case, quotas are usually assigned to foreign producers on the basis of their historic market share. Hence, quotas transfer to the foreign producers the forgone revenue of an equivalent tariff. Such quotas are, of course, more profitable than the equivalent tariff to foreign producers. It is revealing to examine the range over which quotas are more profitable to foreign producers than free trade.

As long as the slope of the residual demand curve facing foreign producers is less than infinite—that is, as long as the elasticity of supply of domestic producers is less than infinite—foreign producers, as a group, face a downward-sloping demand curve, and their profit-maximizing output is less than the competitive (free-trade) output. That is trivial. But how much can imports be reduced before foreign producers' profits fall below the free-trade level?

A simple example demonstrates the magnitudes that might be involved. The supply functions of foreign and domestic producers are constructed so that import supply is slightly more elastic than domestic supply, and under free trade, imports have 40 percent of the market:

(1) Market Demand: $d = 30 - p$
(2) Domestic Supply: $s = -3 + 1.5p$
(3) Import Supply: $i = -12 + 2p$
(4) Total Supply: $t = i + s.$

Where d is quantity demanded, p is price, s is domestic supply, i is quantity imported, and t is total supply. Under free trade, the

[2]Bergsten et al. (1987) present a comprehensive study of the effects of all U.S. quantitative restraints on foreign producers' profits. They estimate that quotas currently in place transfer over $9 billion to those holding the rights to import. The effect of quotas on foreign producers' profits also receives explicit attention in Bhagwati (1989), Deardorff (1987), Kaempfer et al. (1987), Hufbauer et al. (1986), Godek (1985), Clements and Sjaastad (1984), Ono (1984), and Jones (1984). Denzau (1986), Hickok (1985), Tarr and Morkre (1984), and Crandall (1984) are industry specific studies that examine quotas and foreign producers' profits.

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equilibrium price is 10, quantity demanded is 20, domestic supply is 12, and import supply is 8. Figure 1 displays the model.

Now replace import supply with a quota. With linear supply and demand, foreign producers' profits are a quadratic function of the quota level. In this example, the profit (π), quota (q) function is

$$\pi = -.65q^2 + 7.2q. \tag{5}$$

Figure 2 displays foreign producers' profits as a function of the quota level. Foreign profits are computed using the import supply function as the marginal cost function. The quota level is displayed as the ratio of allowed imports to the free-trade level. That ratio ranges from one (free trade) to zero (a complete prohibition of imports).

FIGURE 1

FREE-TRADE MODEL

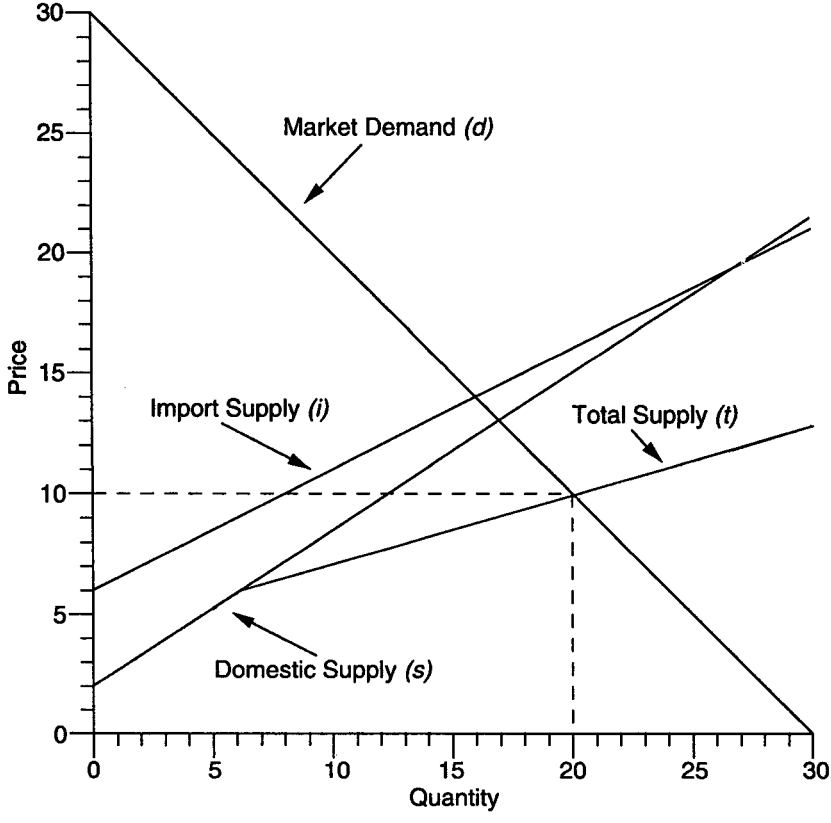

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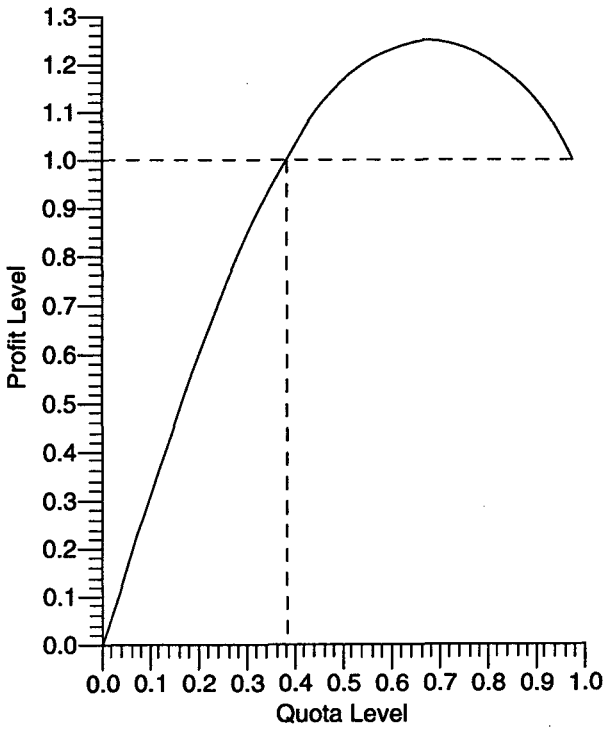
FIGURE 2

FOREIGN PRODUCERS' PROFIT LEVEL AND QUOTA LEVEL



In this example, a quota that allows 69.2 percent of the free-trade quantity maximizes foreign producers' profits. More important, foreign producers do at least as well under a quota as under free trade until imports fall more than 61.5 percent. That is, 38.5 percent is the break-even point for foreign producers. It is the level of imports under a quota, as a fraction of free-trade imports, above which foreign producers' profits will be at least as high as under free trade.

We can solve for the break-even point somewhat more generally, which will also allow us to demonstrate that the more elastic the supply of imports, the greater the range over which quotas raise profits above the free-trade level. With linear functions,

$$d = A + Bp \tag{6}$$

$$s = C + Dp \tag{7}$$

$$i = E + Fp. \tag{8}$$

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Profits as a function of the quota level are

$$\pi = -\{[1/(D - B)] + [1/(2F)]\}\, q^2 + [(A - C)/(D - B) + (E/F)]q. \tag{9}$$

The range, over which profits are above the free-trade level, is defined by the smaller root of the quadratic equation formed by subtracting the free-trade level of profits from the right-hand side of the above equation.

Let p_f represent the free-trade price and q_f the free-trade quantity of imports. The quadratic can then be written:

$$-\{[1/(D - B)] + [1/(2F)]\}\, q^2 + [(A - C)/(D - B) + (E/F)]q - \{(p_f q_f) - [(q_f)^2/(2F)] + [q_f(E/F)]\} = 0. \tag{10}$$

The constant term is the free-trade profit level. We can use the free-trade equilibrium condition $p_f = (A - C - q_f)/(D - B)$ and the identity $E = q_f - Fp_f$ to simplify the equation to

$$-\{[1/(D - B)] + [1/(2F)]\}\, q^2 + \{(q_f/F) + [q_f/(D - B)]\}\, q - [(q_f)^2/(2F)] = 0. \tag{11}$$

The smaller root of that quadratic, as a fraction of q_f, is

$$(D - B)/(2F + D - B). \tag{12}$$

That value is the break-even point for foreign producers. Once again, the break-even point is the level of imports under a quota, as a percentage of free-trade imports, above which profits will be greater than under free trade. Note that that value is a simple function of the slopes and not the intercept terms. For example, regardless of free-trade import shares, if the slope terms are all approximately equal in absolute value, foreign producers' profits increase under a quota unless imports are reduced by more than 50 percent.

Note also how the slope of the import supply function (F) affects the break-even point. The break-even point decreases with F, approaches zero as F approaches infinity, and approaches one as F approaches zero. Thus, for any given domestic supply and demand functions, the more elastic the supply of imports, the larger is the range over which quotas raise foreign profits over the free-trade level. Figure 3 displays the relationship between quota levels and foreign producers' profits for three different values of the import supply response. The values of F used in the figure are 9, 3, and 1. (For clarity, the value of E is adjusted to hold the free-trade import share at 40 percent. Note that the horizontal location of the break-even

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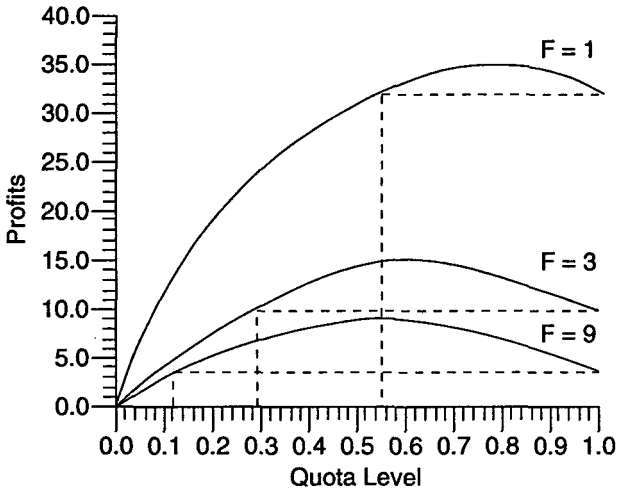
FIGURE 3

FOREIGN PRODUCERS' PROFITS AND QUOTA LEVEL AT VARYING IMPORT ELASTICITIES



point is not affected by whether import shares are held constant in this way. The domestic demand and supply functions are those used in Figure 2.) Only as the import supply response approaches zero does the profit level decline monotonically with the quota level. As the supply response approaches infinity, a foreign producer will prefer any quota level (above zero) to free trade.

While the exact results here depend on linearity, the basic finding is quite general. In many markets, there is likely to be a large range over which quotas can be enforced while increasing the profits of established foreign producers. Given that the market shares of foreign producers are usually not dramatically reduced by quotas, the large rent transfers reported by Bergsten et al. (1987) should not be surprising. With quotas, the political sector can join foreign and domestic producers in an alliance of protectionism, even when imports are significantly reduced.

Political Equilibrium

How do international trade quotas fit into the economic theory of regulation? Following the approach of Stigler (1971) and Peltzman (1976), we explain government policy as a political-support-maximizing tradeoff among competing groups with different lobbying efficiencies—that is, among groups with different levels of influence.

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From that perspective, an import restriction is viewed as a politically efficient method of redistributing rents or market surplus from consumers to producers. The political equilibrium is reached at the quota level that maximizes political support.[3]

The maximization problem representing the political process is easy to describe. The function that relates foreign and domestic profits and consumer surplus, as determined by the quota level, is referred to as the surplus transfer function. A political preference function, which defines political utility or support as a function of domestic profits, foreign profits, and consumer surplus, is maximized subject to the constraint of the surplus transfer function. The political preference function would be pictured as an indifference set (a set of iso-political-utility surfaces in consumer surplus, foreign profit, and domestic profit space) maximized subject to the surplus transfer function (a curved line in that space).

Figure 4 illustrates the equilibrium in two dimensions, ignoring the level of consumer surplus. The figure shows the surplus transfer function for foreign and domestic profits and the maximum attainable level of the political preference function. (In the figure, profits are measured relative to their free-trade levels, so that both values equal one at the free-trade point.)

An important question is: What particular characteristics of the domestic and international markets explain the shape of the political preference function? That is, what makes some industries more powerful than others? For example, why is copper traded relatively freely, while steel imports are constrained by quotas? And why is there a quota on Japanese automobiles, while Japanese motorcycle and light-truck producers face high tariffs? Those questions have received a good deal of attention from economists, although distinguishing between tariffs and quotas is a relatively new line of inquiry.[4]

[3]Hillman and Ursprung (1988) present a rigorous model of the political economy of alternative forms of trade restriction. Their paper also contains a useful survey of the literature.

[4]For empirical studies of the relation between domestic industry characteristics and types of trade restriction, see Godek (1985), Ray and Marvel (1984), Marvel and Ray (1983), Ray (1981), and the papers they cite. Magee et al. (1989) is a useful survey. For example, as summarized in Godek (1985, p. 700): "Quotas do appear to be a distinct regulatory entity. They are more likely to exist and be more restrictive in larger or more geographically concentrated industries. Tariffs, on the other hand, decrease with the number of firms and increase with the share of the market dealing in final goods. The incentive to generate either type of trade restriction is strongly and inversely related to the average wage." The influence of foreign producers has not yet been controlled for in any systematic way.

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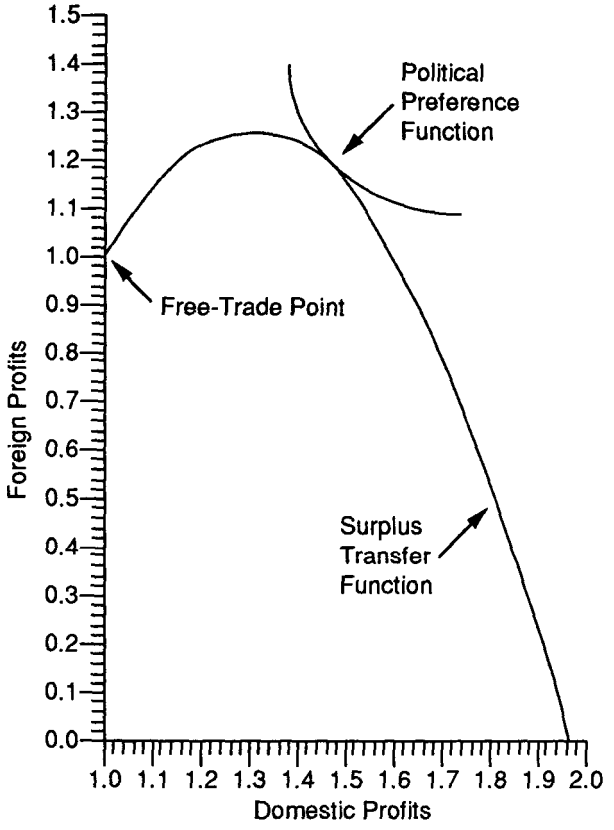
FIGURE 4

POLITICAL EQUILIBRIUM



The simple presumption here is that, like the domestic producers, foreign producers may be able to directly influence the political process. Foreign producers may also be able to lobby their governments to intercede on their behalf. Or, as will be discussed, they may be able to bring legal action under international trade agreements to oppose tariff increases. Thus, foreign producers will have varying degrees of influence over the type and level of trade restrictions they face. And as we have seen, if foreign producers are to face a quota, they may not be ardent supporters of free trade.

If we refer to Figure 4 again, corner solutions are possible although rare in practice. If consumers have no political influence (have no weight in the political preference function), imports still may not be totally prohibited. Only when consumers and foreign producers both

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lack political influence will no imports be allowed. If foreign producers are very influential, relative even to domestic producers, quota levels may approach the foreign producers' profit-maximizing level. If domestic and foreign producers have no political influence, trade will be unencumbered.

The political sector can also choose the surplus transfer function generated by a tariff. In that case, foreign profits and consumer surplus both decline monotonically with imports. A tariff may be used when foreign producers have no political influence or if quotas are particularly difficult to administer in a given market. One of the political benefits of a tariff is, of course, the revenue collected.

However, the imposition of tariffs is more effectively constrained by international trade agreements than are quotas. The case has been made that quotas are used specifically to circumvent those agreements. Tumlir (1985) has argued that discriminatory quotas are used to benefit foreign producers because those producers could successfully challenge increased trade restrictions under the General Agreement on Tariffs and Trade.

The prohibition of high tariffs by international trade agreements may explain the increased use of quotas in recent years. The trade agreements lowered tariffs below their political equilibrium levels. That is, many industries that found themselves with less tariff protection still had the influence necessary to generate a replacement, the discriminatory quota. And the replacement allowed the industries to add another group, the foreign producers, to the lobbying coalition. From that perspective, the increased use of quotas is the ironic result of trade agreements that effectively prohibited high tariffs.[5]

Also, it has been observed that quotas are often used to supplement tariffs. That is, industries that already enjoy a high degree of tariff protection are more likely to be further aided by nontariff barriers.[6] That observation is consistent with the explanation that quotas are used to circumvent international trade agreements. After such agreements, industries with lowered but still higher-than-average tariffs receive further protection with quotas. Similarly, it may be that a tariff is used initially to grant protection. If further protection is required to reach political equilibrium, a quota may then be used, both to appease the foreign producers and to avoid a tariff in excess of agreed-upon levels. In either case, it should be observed that the quota makes the tariff redundant, not vice versa.

[5]That analysis implies that the separate industry lobbying groups were unable to form a single coalition in order to stop the trade agreements.

[6]See the papers cited in footnote 4, in particular Godek (1985, pp. 693–701).

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There is extensive literature on the non-equivalence of tariffs and quotas under different regimes of uncertainty. The consequences of uncertainty can also give quotas a political advantage over tariffs.[7] Quotas mandate precise quantities or market shares without the need to determine or adjust the tariff levels necessary to accomplish the same result. Thus, increased exchange rate volatility may have made quotas preferable and may help explain their recent popularity. In a world of import-level volatility, quotas can simplify the process of protectionism.

From that perspective, quotas can confer another benefit on foreign producers. A quota that specifies a given quantity, as opposed to a market share, can increase the cyclical volatility of domestic production and decrease the volatility of foreign production.[8] Under free trade, an elastic supply of imports insulates the domestic industry from shifts in demand. With a quota, however, the market share of imports is procyclical and shifts in demand are transmitted directly to the domestic industry. In such cases, it would seem that domestic producers are willing to forgo lower variance for a higher mean or that foreign producers are particularly influential.

Many economists have also studied the non-equivalence of quotas and tariffs when the domestic industry is not competitive.[9] Those studies derive interesting results concerning the relative economic and political efficiency of quotas, but they generally do not help us understand the increasing use of quantitative restrictions over time. There is no systematic evidence that the choice of quotas reflects market power in the domestic market, although that may be a fruitful avenue for future research.

Conclusion

The international trade quota can serve determined political goals. It is a policy tool that includes foreign producers as beneficiaries in the process of redistribution in order to circumvent international trade agreements.[10] Since the 1970s, the allocated quota has disrupted and reversed progress toward free trade. In steel, textiles, automobiles, computer chips, and several agricultural products,

[7]Deardorff (1987), McCulloch (1987), Lloyd and Falvey (1986), and the papers they cite discuss the effects of uncertainty on the political choice of tariffs versus quotas.

[8]Hickok (1985) makes that point succinctly.

[9]See Helpman and Krugman (1989), Anderson (1988), Kaempfer et al. (1987), Cassing and Hillman (1985), Ono (1984), and the papers they cite for recent examples.

[10]From that perspective, suggestions that quota rights be auctioned are naive. Such auctions would duplicate the effects of a tariff and, thus, defeat the political purposes of the quota.

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international cartels have been formed and policed under government auspices. Unless countries relinquish the use of discriminatory quotas, international trade may continue to degenerate into formalized market-sharing agreements.

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Property Rights and Rent Seeking in South Africa

John M. Mbaku

Introduction

Competition for resources existed in South Africa long before the arrival of Europeans. Ethnic groups fought each other for control of land use rights. The fighting was centered around the right to use the land for hunting, gathering, and the grazing of cattle. The introduction of European settlers to the area in the mid-1650s intensified the struggle for resources. European colonists brought with them large-scale, or plantation, farming that required large tracts of land. In addition, the new farmers preferred land ownership under private property rights to the common access approach that was prevalent in most of the country. The introduction of private ownership rights in land intensified black-white strife and set the stage for a bitter struggle between the two groups for the control of property rights. That struggle became an important part of the history of the region.

In the struggle for political control of property rights in modern South Africa, one recognizes two major groups, whites and nonwhites. The former is made up of Afrikaners and South Africans of British descent. The latter consists of Africans (usually referred to as blacks), Asians, and coloreds (coloureds). Afrikaners are white South Africans of Dutch-German-French descent. They currently make up about 60 percent of the white population but only 10 percent of the population of the country. The rest of the white population consists primarily of people of British descent. In South Africa, only whites have full civil and political rights. Afrikaners dominate the political life of the country and use the policy of apartheid, or separate

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development, to protect their privileged political and economic positions through the subjugation of blacks, Asians, and coloreds. Afrikaners also dominate law-making, the police, the army, the judiciary, the educational system, and many other aspects of life in South Africa. Coloreds, who currently make up about 10 percent of the population of the country, are inhabitants of South Africa who are officially recognized as being of mixed origin and partly white. The colored population of South Africa dates back to 1657, when white settlers or colonists took African (mainly Khoi-Khoi and San) and Asian women as partners because of a shortage of white women. Most coloreds speak Afrikaans, the language of the Afrikaners, and live primarily in western Cape Province (Phillips 1984, pp. 35–36, 42–43; Williams 1989, pp. 1–2).

Blacks in South Africa are members of several ethnic groups that are exclusively of African ancestry. Until 1978, the government of South Africa usually referred to them as Bantus. Asians are mainly descendants of people brought from Asia by the British in the 19th century as contract laborers. Most Asians in South Africa today are of Indian descent. They live primarily in Natal and southern Transvaal.

It must be noted that none of the different racial groups in South Africa are homogeneous. Blacks, for example, consist of many ethnic groups, each with a distinct language and culture. Major black ethnic groups include the Zulus, the Xhosas, the Sothos, the Tswanas, and the Tsonga (Williams 1989).

Although coloreds and Asians have also been affected by government regulation of political and economic markets in South Africa, this study is limited to an examination of the exploitation of blacks. Blacks represent over 70 percent of the population of South Africa and have suffered greater indignities than any other ethnic group in the country. In addition, blacks remain at the bottom of the economic ladder. Although coloreds and Asians have been granted limited access to political and economic markets, blacks continue to be denied most forms of political participation.

When industrialization began in South Africa at the turn of the century, many rural farmers, primarily Afrikaners, migrated to the urban areas in large numbers. The exodus was precipitated primarily by declining returns on farming and the promise of a better life in the urban industrial sector. The migrants brought with them skills that were essentially useless in the urban sector. In addition, they were unwilling to do menial tasks, the only jobs for which they were qualified. Also, they were overwhelmed by a culture that was essentially alien to them. While most of urban South Africa spoke English at the time, most Afrikaners spoke primarily Afrikaans. They

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were unable to compete with other ethnic groups for jobs in the South African industrial sector. Afrikaners were universally thought to be lazy and unreliable workers who suffered from a "high rate of absenteeism and a tendency to quit unexpectedly" (Fredrickson 1981, p. 231; Hazlett 1988, p. 89; Hutt 1964, pp. 32–37). The most threatening competitor of the new immigrants in urban South Africa was black labor. Afrikaners believed that the only way they could successfully compete with black labor was through labor market regulation (Hazlett 1988, pp. 90–91).

Another participant in the emerging economic conflict was non-Afrikaner white labor, mostly of British descent. They, too, faced competition from black labor and, like Afrikaners, were determined to use legislation to fight black competition in the labor market.

The third and fourth participants in the conflict that was to engulf the country for most of the 20th century were white capitalists and, of course, black labor. White capitalists sought ways to minimize production costs and preferred an unregulated labor market. They were attracted to the ultra-cheap black labor that existed in the country. That preference eventually led to a bitter confrontation between white capital and white labor (Fredrickson 1981, p. 222).

One should not be led to think that South Africa had a free labor market in the early years of industrialization. Although the labor market at the time was relatively free of regulations, black workers were harassed continuously by white labor, white farmers, and even the police. In addition, "pass laws" limited black mobility and, as a result, significantly affected the competitiveness of the labor market. White mining capital, represented by the Chamber of Mines in the Transvaal, campaigned for a reform of the pass laws to increase black mobility and help black workers "travel freely and securely" (Hazlett 1988, p. 91; Doxey 1961, pp. 55ff). Afrikaners in the Transvaal mining district opposed such reforms, and the mining companies were unable to improve the mobility of black workers (Hazlett 1988, p. 91; Doxey 1961, pp. 55ff).

Afrikaner interests and white labor came to rely more and more on state regulation for help in the attempt to develop a competitive edge over black labor. Both groups believed that their welfare lay in the exclusion of blacks from productive positions in the South African economy. Exclusion of blacks was to be undertaken through the political control of property rights, a process that would eventually lead to white control of most of the land in the country and of the labor market. In this article, I shall argue that South Africa is a "rent-seeking society" in which white labor and Afrikaner farming interests extract rents from the economy through their political control of

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property rights assignments. Below, I present a further development of the political economy of rent seeking in South Africa by examining regulation from a property rights perspective. Specifically, this paper will attempt to show that the black-white conflict in South Africa has its origins in the political competition of interest groups for control of property rights.

Property Rights and Rent Seeking

The relationship between rent seeking and property rights has been recognized by many researchers. Buchanan and others have shown that the process of assigning property rights can lead to rent seeking, which usually occurs when the state controls property rights or "can easily assign and transfer rights that are supposedly in private hands" (Benson 1984, p. 396; Buchanan 1980a; Buchanan 1980b; Buchanan 1980c; Buchanan 1983).

An individual who attempts to capture a given property right has three options. First, he can negotiate to buy the right from its owner in a voluntary private exchange. Second, the individual may get the government to seize the right from its present owner and reassign it to him. Finally, the individual can resort to theft. The economic agent will usually choose the method that allows him to minimize his costs of capturing the existing right. When the government is brought into the game of capturing and reassigning property rights, opportunities for the political manipulation of rights arise. Rent-seeking activities of that sort involve attempts by interest groups to "define, reassign, modify, or attenuate property rights" (Benson 1984, p. 398).

The political competition for property rights involves several options. First, the politically dominant interest group may have the government seize the property rights from the owners and reassign those rights to group members. That can be accomplished by passage of legislation that results in a direct transfer of rights. For example, the Natives Land Act, passed by the Union Government in South Africa in 1913, transferred a significant number of black rights in land directly to whites. Second, the state may create new rights and assign them to members of the dominant group; state-created new rights that benefit the dominant group abound in segregation laws in South Africa. For example, color bar legislation in South Africa, which reserved most skilled positions in industry for white labor, created new property rights that benefited the latter group.

Third, the state can put restrictions on the exercise of rights by certain groups within the economy, making those rights valueless to their owners. The dominant group may then assume ownership of

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those rights since the legislation usually does not prevent that exercise by members of the dominant group. Fourth, the state may pass laws improving the security of the property rights of members of the dominant group, while at the same time, weakening the security of rights held by minority group members. All those actions are taken to increase rents accruing to members of the dominant group.

The political struggle for the control of property rights in the Republic of South Africa has involved two major areas: land ownership and the industrial labor market. We shall begin the analysis of the political allocation of resources in the country by examining the struggle between whites and blacks for control of employment opportunities in the industrial sector.

Color Bar Legislation and Political Competition for Resources

The era of color bar legislation was ushered into South Africa with the events of 1907. That year, violent strikes occurred in the Rand mining district, and the government responded by bringing Afrikaners into the mines as trainees. Incumbent miners, primarily whites of British descent, regarded the new miners as scabs. The skilled miners expressed great anger at a government they had helped bring to power and demanded that the Afrikaner trainees be removed from the mines. In response to pressure from the Miners' Association, and to retain the skilled miners' political support, the government passed the Transvaal Ordinance no. 17 of 1907. The new law was designed to protect white miners against skilled competition from the Chinese. That legislation paved the way for the two color-bar acts that were to follow (Hutt 1964, pp. 61–63).

It should be noted that the main objective of Afrikaner politicians at that time was to improve living standards for Afrikaners, many of whom lived in extreme poverty in the urban areas. A very large number of Afrikaners, displaced from their farms, migrated to the urban areas and lived in crowded, unhealthy quarters. Their leaders were determined to improve living conditions and bring them up to par with those of the English-speaking, white South Africans. It was the method chosen to effect changes in the living standards of these poor whites that legalized what had previously been tradition and custom among the Afrikaners—hatred of nonwhites. Had Afrikaner leaders chosen to solve the problem of white poverty through reliance on free markets, the color bar might never have developed, at least not to the extent to which it exists in South Africa today. In its attempts to improve the quality of life for poor whites, the

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government was quite inept. That objective could have been achieved more efficiently and at less cost if the government had relied more on free markets and less on state intervention (Omond 1986, Hutt 1964).

Since the government had decided to confront the problem of white poverty through labor market regulation, it was inevitable that its policies would conflict with those of capitalists who were interested in low-cost production. The latter preferred an unregulated labor market. The government believed that unless black participation in the industrial sector was limited by law to the performance of unskilled tasks, white workers and their unions would use private violence to effect such exclusion.

On the eve of independence from Great Britain, severe labor conflicts ravaged South Africa as white labor continued to pressure mine operators to exclude blacks from the majority of skilled positions in the mines. White labor was determined to use force (private or state) to serve its interests. With the support of Afrikaners, labor unions pressured the new Union Government to pass the Mines and Works Act of 1911. Also known as the Color Bar Act, that law was designed as a concession to socialists and labor unions. The government also hoped to appease Afrikaners, many of whom were violently opposed to black competition in the industrial sector. The new law called for the government to issue work certificates for most mining jobs, supposedly to improve employee safety. Most certificates of competency, however, were issued only to white workers. In fact, in Transvaal and Orange Free State, the issuance of such documents to nonwhites was specifically prohibited by the Mines and Works Act of 1911 (Hutt 1964, Williams 1989).

That law did several things. First, it created new property rights for white labor, allowing white workers to receive significant rents from the economy through the higher wages that accompanied the labor market regulation. Second, the law placed significant restrictions on black property rights—denying blacks the right to enter certain job categories created an implicit tax on their labor and a direct transfer of wealth from them to white labor. The law also improved the security of white property rights and weakened that of black property rights. In addition to black labor, white capital also suffered a loss in wealth as a result of the legislation. It should be recognized that residents of South Africa ended up with a lower average standard of living as a result of that and other color bar laws. The laws constrained the proper functioning of the market and resulted in lower production and lower national income. It is interesting to note that the most ardent supporters of the establish-

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ment of an industrial color bar were workers who had not bothered to upgrade their skills and had to rely primarily on union action and political pressure for high wages. The capitulation of the government to union pressure paved the way for the establishment of a political resource allocation system.

Until 1922, cooperation between white labor and Afrikaners was on an informal basis, deriving primarily from the realization that both groups had similar goals. There was a desire, on the part of both to restrict black economic activities. That was to be achieved either by putting significant restrictions on the exercise of property rights belonging to blacks or by seizing those rights and reassigning them to whites. In 1922, South Africa was faced with extremely violent labor strikes, sponsored by the all-white Mine Workers' Union that protested the mine operators' decision to raise the ratio of blacks to whites in the mines. The strikes were led by English socialist William Henry Andrews, who was to play an increasingly important role in the fight to preserve white privileges. Most of the rebelling miners were Afrikaners, but socialists (primarily workers of British descent) also participated in the revolts. The 1922 strikes bolstered the image of the South African Labor party, which formed a coalition with the Afrikaner-dominated Nationalist party to win the election of 1924 and form what is usually referred to as the Labor-Nationalist "Pact" Government. The new government supported the principle of white supremacy and permanent nonwhite inferiority. The capture of the apparatus of state power by white labor and Afrikaner farmers set the stage for massive state intervention in the labor market. Such intervention was to take place through influx control laws and color bar legislation. That coalition of convenience came to dominate the Republic of South Africa for most of this century (Nattrass 1981, pp. 75–76; Van der Horst 1965, p. 177; Hutt 1964, pp. 68–70; Williams 1989, pp. 37–38).

The coalition's interest in politics was based primarily on the realization that lobbying had not been very effective in getting legislation passed to attenuate or abrogate black property rights. It knew that the most effective way to ensure that the apparatus of government was used to help its members control property rights was to capture it. The new government immediately proceeded to pass laws that effected changes in the structure of property rights. The legislative agenda of the Pact Government was designed to help whites (Afrikaners and white labor) win against black labor and white capital in the competition for control of property rights.

Shortly after it took power in 1924, the Pact Government immediately proceeded to pass laws to limit black participation in the

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economy. That year, the Industrial Conciliation Act was passed. It established wage councils (whose membership came from employers and white trade unions) that were to "establish 'rate for job' pay levels across individual occupational categories in major sectors of the economy" (Hazlett 1988, p. 93; Nattrass 1981, p. 76).

In 1925, the Pact Government passed the Wage Act and extended minimum wages, established by the Industrial Conciliation Act, to non-unionized industries. The two pieces of legislation reduced competition of relatively unskilled and uneducated black workers in the labor market, fulfilling what had been white labor's original intent when it sought government protection. Despite those tremendous gains, white labor continued to press the government for additional laws. In 1926, the government decided to resurrect the provisions of the Mines and Works Act of 1911, which had been killed by the courts in response to a challenge by the Chamber of Mines. The Mines and Works Act of 1926, also called the Second Color Bar Act, was supposedly designed to "counteract the force of economic advantages at present enjoyed by the native," as stated by the government's Mining Regulations Commission (Doxey 1961, p. 160). The 1926 legislation was a reflection of the belief of most whites, especially labor, that the presence of blacks in the labor market represented unfair competition and that the welfare of whites would suffer significantly if blacks were not legislated out of the market. The law strengthened the barriers against nonwhite advancement provided for in the 1911 act. The Industrial Conciliation Act no. 11 of 1924, the Wages Act no. 27 of 1925, and the Mines and Works Amendment Act no. 25 of 1926 "legally entrenched the concept of White labour supremacy" in South Africa (Nattrass 1981, p, 76; Williams 1989).

Civilized Labor Policy

The welfare of poor whites in urban areas, many of whom were unable to benefit from existing labor market regulation because of their lack of skills, remained an important problem for legislators. Interestingly enough, much of the restrictive labor market legislation actually had a negative effect on many poor whites because they did not possess the minimum skills needed to qualify for apprenticeships and other protected job categories. To confront the problem of white poverty, the government introduced its civilized labor policy that effectively set aside certain jobs in the public sector for whites. The policy also gave preferential treatment to industries that hired a significant percentage of civilized labor (Nattrass 1981, p. 76). The new policy allowed the government to use parastatal agencies as

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income transfer schemes to allow significant rents to accrue to poor whites. As a result of the promulgation of that policy, a large number of blacks were dismissed from their jobs (Nattrass 1981, p. 76). Although designed primarily to prevent a fall in the living standards of whites, the policy was also used to ensure that the differential between whites and nonwhites was maintained, making certain that whites would continue to retain special privileges.

Since it did not impose any overt color bar, the civilized labor policy was easily approved by those who felt socialism implied some form of equality. It relied on four major pieces of legislation; two laws, the Factories Act of 1918 and the Apprenticeship Act of 1922, had already been enacted. The new government used the provisions of those laws as the foundation for the new labor policy and passed two additional pieces of legislation to strengthen it. The Factories Act permitted the minister of labor to withdraw customs duties exemptions on raw materials for firms employing nonwhites when it was determined that whites were available to perform the tasks in question. In addition, the act required that separate facilities be provided whites and nonwhites in restrooms, canteens, and other common areas. The law significantly raised the cost of employing nonwhites for the first time (Hutt 1964, Williams 1989).

The Apprenticeship Act reserved most high-paying jobs for whites and weakened the incentive for self-improvement among white workers. The Industrial Conciliation Act no. 11 of 1924 was the first law enacted by the Pact Government to strengthen the civilized labor policy. Next, the government passed the Wage Act no. 27 of 1925 that was designed to cover areas primarily not affected by trade unions. Its main purpose was to protect unskilled white workers from nonwhite competition. The exclusion of blacks from full participation in the South African economy decreased the level of overall development in the country and contributed to a lower standard of living for all groups, including whites.

The civilized labor policy had several effects. First, it benefited primarily skilled whites. Minimum wage regimes and apprenticeship laws established under the policy excluded nonwhites and a large number of unskilled whites (primarily poorly educated Afrikaners). Second, the laws significantly reduced labor efficiency and resulted in lower output levels. Third, businesses were forced to hire unskilled, white labor in protected areas, while nonwhite talent was wasted, which significantly lowered national output. Fourth, overcrowding was caused in occupations that were opened to nonwhites. Finally, that set of laws destroyed incentives for white labor to improve its skills. Many whites, shielded from the rigors of competi-

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tion by government regulation, failed to improve their efficiency. In addition, the civilized labor policy also put significant restrictions on the profit motive and reduced its ability to improve the welfare of South African society. The Labor party had hoped that the civilized labor policy laws would keep blacks permanently out of the industrial sector. Profit-maximization by the private sector, however, forced a compromise that allowed the policy to ban Africans only from semiskilled and skilled jobs. Africans were allowed to occupy positions in the unskilled trades. Had South African government authorities allowed markets to operate freely by giving blacks unrestricted access to the economy, national production would have been considerably higher and the quality of life for all South Africans would have been much higher than it has been (Hutt 1964).

Thanks to the efforts of the Pact Government, by the end of the 1920s, South African whites were receiving significant transfers from the economy through two distinct systems. First, wage fixing and occupational licensing protected skilled and semiskilled whites in the private sector from nonwhite competition, which allowed the former to receive significant rents. Second, the civilized labor policy provided employment for poor whites in public agencies at wages higher than prevailing wages for labor with similar skills. The only jobs left for most blacks were the menial ones, all of which paid very little (Van der Horst 1965, p. 121; Hazlett 1988, p. 94; Nattrass 1981, p. 76).

Competition for Rents and the Abrogation of Black Property Rights in Land

Formal abrogation or attenuation of black property rights in land may be said to have begun with the Natives Land Act no. 27 of 1913. The law limited African rights in land to those areas already occupied by them. It effectively froze the quantity of land available to African groups without taking population growth into consideration. In addition, the law prohibited Africans from buying land outside their reservations and outlawed the practice under which Africans had lived on white-owned farms either as sharecroppers or rent-paying tenants (Magubane 1979, pp. 80–82; Nattrass 1981, pp. 70–71; Williams 1989, pp. 29–30).

The 1913 legislation accomplished many things. First, it created new rights for whites, since most of the land was reserved for white use. Second, it made more land available to whites at prices that were significantly lower than they would have been with black competition. Third, it uprooted many Africans and forced them into wage

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labor either as field hands on white farms or as cheap labor in white factories. The areas reserved for Africans became labor reservoirs for white economic activities. From a property rights point of view, the Natives Land Act of 1913 created new rights for whites, abrogated African communal and private rights in land, and reassigned those rights to whites. Although the law was passed to deal with land problems, it served a double purpose. It provided whites with a cheap source of labor. In effect, the law transferred significant amounts of wealth from blacks to whites (Magubane 1979, pp. 81–82).

In 1936, the government passed the Bantu Trust and Land Act, which re-enforced the provisions of the 1913 law. The 1913 act and its 1936 amendment effectively limited African access to land (both tribal and private) in South Africa to about 13.7 percent of the country's total land area (Nattrass 1981, p. 191; Williams 1989, p. 30).

It is interesting to note that South Africa is the only contemporary country in which property rights in land depend on one's skin color. Land ownership is, perhaps, one of the most complex issues in the political economy of South Africa. Land distribution in South Africa in 1980 shows how effective the Natives Land Act of 1913 and subsequent legislation were in abrogating black property rights to land. Of a total of 122 million hectares of land in the country, whites, who make up less than 20 percent of the population, occupied 81.2 percent by 1980. Blacks who are legally allowed to live in white areas occupied 3.6 percent; 12.8 percent of the land is reserved for black occupation and represents the reserves or homelands. It is important to note that in South Africa, although occupation usually implies land ownership for whites, coloreds, and Indians, occupation is not synonymous with land ownership for blacks in white areas. As a result, the 3.6 percent of the land occupied by blacks legally allowed to live in white areas does not actually belong to them since they cannot obtain freehold title to it. It belongs to whites. In terms of ownership, then, whites actually own 84.8 percent of the land (Daniels 1987, pp. 2–3).

During World War II, an adjustment was made in the structure of property rights to allow long-term occupancy of the land to blacks who were legally allowed to live in white areas. Under what was called the 30-year leasehold scheme, legal blacks could petition the government for land to build a house or a stand that included a house. The individual who held the lease for 30 years had the opportunity to request another 30-year extension. The program was designed to manage the extraordinary migration of blacks to urban areas after the war. The influx of blacks to urban areas created severe shortages in housing and resulted in overcrowding in many of the slums, in which blacks found themselves living. However, the leasehold program did

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not help alleviate the housing problem. For one thing, financial institutions were unwilling to extend credit to blacks to build houses because the leases could not be used as collateral. In addition, in 1968, the government began to require that blacks who were interested in participating in the program must accept citizenship in a homeland as a precondition for acceptance. By 1975, more than two-thirds of the houses in most black townships were owned by the government, an indication of how poorly the leasehold program had performed.

In recognition of the failure of the 30-year leasehold program to meet the housing needs of urban blacks, the government introduced the 99-year leasehold scheme in 1978. The new law, called the Bantu (Urban Areas) Amendment no. 97 of 1978, made it possible for blacks legally allowed to live in white areas to lease land, make improvements on it, and transfer their rights to the land to other individuals during the 99-year period. The transfer could be accomplished through a sale, donation, exchange, or bequest (Daniels 1987, p. 4). Since the new law allowed leaseholders to use the rights in the lease as collateral for loans, the 99-year lease program was considered superior to the 30-year scheme. Many blacks, however, were unable to participate in the 99-year program because of the high costs associated with obtaining a leasehold. For example, in 1981, leasehold applicants were required to pay R6 as a processing fee, to pay R300 for surveying the property, and to be responsible for additional expenses that ranged from R450 to R2,000, depending on where the property was located. As a result of those obstacles, many blacks were unable to take advantage of the 99-year program, and, by 1981, many of them were still renting houses from the government (Davenport 1977; Daniels 1987, pp. 3–5).

To obtain greater insights into the extent of the abrogation of black property rights to land since whites first settled in South Africa, one can examine the land-to-man ratio. Data show that, in 1980, while each white had available to him, on average, 21.9 hectares of land, only 1.42 hectares of land were available to black South Africans living in the homelands and 0.43 hectare was available to those living in white areas during the same period. Also significant is that land ownership in the homelands is communal and does not provide for free leasehold title. In fact, residents regard that land as government reserves and have subsequently exploited it. Individuals are reluctant to make any investments in land improvements because of free rider problems that are prevalent in most communal rights systems. Although open access is a characteristic of African customs and is not a white creation, the government has not made any attempts to

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encourage the development of private property rights that could benefit black communities. The open access approach, especially in the face of overpopulation, has contributed significantly to the destruction of the quality of the land (Daniels 1987, p. 5; Davenport 1977; Nattrass 1981, p. 194).

The severe inequality in land ownership may be traced to the activities of white South Africans who have been able to use the coercive force of the government to dispossess blacks of their property rights to land. Manipulation of property rights has been the case since whites first arrived in the area in 1652. Europeans who arrived at the cape in the mid-1650s assumed that African land owned under common property rights did not really belong to anybody and, therefore, was available for immediate occupation. In 1880, Earl Grey, an English colonist, expressed the feelings of most whites toward the land question in South Africa. He remarked that most whites felt that when the interests of whites came into conflict with those of nonwhites, the needs of the latter should be disregarded. Choices made, many of them believed, should reflect an attempt to maximize the interests of the "superior race." For whites to continue to maintain an advantage over other races, they believed that "facilities should be afforded to the white colonist for obtaining the possession of land theretofore occupied by the Native tribes" (Magubane 1979, p. 71). That view of land ownership allowed whites to abrogate African communal property rights, eventually resulting in the severe inequality of land ownership that exists in the country today. Not only do whites own over 80 percent of the land, they also own the most cultivable land in the country. Land ownership patterns in South Africa, thus, have resulted primarily from government confiscation and reassignment of rights.

Apartheid and the Political Struggle for the Control of Property Rights

By the start of World War II, the abrogation of black property rights in land and labor was nearly complete. In fact, the structures accounting for the labor situation and black destitution in South Africa today were completely in place by that time. Although many writers attribute the present condition of blacks in South Africa to apartheid legislation, a significant number of the laws that have contributed to the loss of most black property rights were enacted prior to 1948, the year apartheid was formally introduced into the country. What apartheid proponents did was build on existing legislation, pass other laws to strengthen and improve the security of white

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property rights, and finalize the confiscation of black rights. After they returned to power in 1948, the Nationalists further restructured property rights to make white rights more secure and weakened the few rights that were left to blacks after the mass abrogation achieved through legislation passed between 1911 and 1948. In addition, the institutions responsible for controlling the flow of black labor were streamlined to make them more efficient. The restrictions placed on owners of capital by the government represented an infringement on their ability to maximize profits. Thus, a significant number of the laws designed to benefit white labor and Afrikaner farming interests actually put significant restrictions on the exercise of private property rights belonging to capitalists (Nattrass 1981, pp. 76–77).

Afrikaners and white labor knew that profit-maximizing capital would eventually opt for a colorblind labor market. There was fear among many Afrikaner Nationalists and white labor that white capital would eventually promote the passage of legislation permitting closer intergroup relations. The economic integration that would result from such a policy of racial coexistence, they felt, would threaten the welfare of whites. Many believed that the existing structure of property rights that provided them with a significant number of benefits could not be passed from generation to generation unless the strict separation of races was maintained. Olson writes that "the system could not possibly survive for many generations unless the demarcation between the races was preserved" (Olson 1982, p. 164). A significant amount of the legislation passed after 1948 was designed to put permanent social and geographic distance between racial groups in South Africa. The Prohibition of Mixed Marriages Act of 1949 strengthened the restrictions placed on interracial relations by the Immorality Act of 1929. Subsequent legislation, including the Group Areas Act of 1950 and the Separate Amenities Act of 1953, resulted in complete residential segregation and separation in public places (Brookes 1968, Williams 1989).

Despite the obstacles imposed on it by legislation, the profit motive has been responsible for most of the economic progress that has occurred in the Republic of South Africa since the 1930s. According to Hutt, "the whole prosperity and economic expansion of South Africa has been due to the use of non-white labour in occupations and grades of work which would have been prevented for all time if the restrictionist-minded Labour Party members of the 'Pact' Government of 1924 had had their way" (Hutt 1964, p. 85). In fact, most of the improvements in the living standards of poor whites were due primarily to the activities of capitalists, not to government regulation. Without the ability of capitalists to penetrate or by-pass government

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restraints, the poor white problem would have been a permanent part of urban South Africa. The solution to that problem required more productive use of nonwhite labor. Government ineptitude, thus, has contributed significantly to the problem of poverty in South Africa. The functioning of free markets, although limited, has been responsible for most of the development that has occurred in the country.

Conclusion

The conflict in South Africa between blacks and whites had its origins in the activities of groups trying to protect their interests by politically controlling property rights assignments. With the help of the coercive force of the government, a coalition of white labor and Afrikaner farming interest groups abrogated black rights in land and labor. Most of the black rights in land have been transferred to whites and, through labor market regulation, significant restrictions have been put on the exercise of black labor rights. Those activities have resulted in a concentration of wealth in the hands of whites. The majority of blacks in the country are landless, cannot sell their labor services at market prices, and live in severely congested areas.

The current political and economic condition of blacks in South Africa can be traced to the successful abrogation and attenuation of their property rights by whites. Although the challenge South Africa now faces is how to dismantle apartheid, a bigger, and perhaps more explosive, problem is land reform. Only time will tell if black property rights to land will be restored once a democratic system is introduced in the country.

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GOVERNMENT V. COASE: THE CASE OF SMOKING

Dwight R. Lee

Introduction

A significant amount of political influence is being exercised in support of increasing the taxation and regulation of smoking. The federal excise tax on cigarettes was doubled in 1984, and further increases were recently approved. By federal law, smoking has recently been prohibited on virtually all domestic commercial flights; the previous prohibition of smoking on flights of two hours or less (which includes the vast majority of domestic flights) was not considered sufficiently restrictive. At the state and local level, there has been a multitude of ordinances passed that restrict smoking in both public and private establishments, and one state and city after another has steadily escalated excise taxes on cigarettes.

The motives that lie behind increases in governmentally imposed burdens on smokers are no doubt many and varied. There are always a few well-meaning people who are burdened with superior wisdom about how others should live their lives. Those people have always found government force more convenient than persuasion as a means of sharing their wisdom with others. Politicians are constantly alert to opportunities to obtain more tax revenues at minimum political risk. Certainly, they have not been oblivious to the shift in public opinion against smoking, or to the fact that smokers have not only become a minority of the voting age population but a minority increasingly concentrated in the lower income classes that are less likely to vote than the more affluent.

Regardless of the real motives, however, political burdens are always easier to impose when they can be justified on grounds more noble than elitism, paternalism, and the desire for more of the

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public's money. For that reason, government policy recommendations are inevitably brought forth with a heavy veneer of public interest rhetoric. In the case of tougher restrictions and higher taxes on smokers, the argument is that those measures are needed to reduce the economic costs and inefficiencies that result from the use of cigarettes.

There has been a steady stream of studies in recent years that purport to show that smoking is costing the American public enormous sums. For example, Secretary of Health and Human Services Louis Sullivan recently released a study that claimed that the cost of smoking is over $52 billion annually.[1] That figure is, for reasons that are discussed subsequently, a gross overstatement. But whether the HHS figure is accurate or not, in the absence of further information, the cost of smoking is entirely irrelevant as far as public policy is concerned. What is the cost of billiards, bowling, or sunbathing? While those may be interesting questions to merchants who sell pool tables, bowling balls, and suntan lotion, there is no public policy significance that attaches to the answers. Everything people do involves costs. As long as those who engage in an activity pay the costs, they can best assess the benefits and decide how much or how little to spend on the activity.

Only if it can be established that the full cost of a product is not being paid by those who consume it is it possible to make a reasonable case that the public interest requires imposing a differential tax on the product or restricting its use. So the relevant public policy question regarding smoking is not how much smoking costs but how much, if any, of the costs are paid by nonsmokers.

Not surprisingly, those who favor higher taxes on cigarettes and tougher restrictions on smoking claim that smokers are not paying their own way. Supposedly, smokers impose costs on nonsmokers, and indeed the whole of society, through lost productivity, greater demands on health care, and irritating side-stream smoke. The interesting thing about those claims is that most people simply accept them as true. Little effort has been made to carefully examine the assertion that smokers fail to pay much of the costs of smoking or to question the automatic conclusion that that failure, even if it does exist, justifies a public policy to reduce smoking. In fact, when the evidence is carefully examined, no support can be found for the claim that smokers are not paying their own way.

Much of the confusion and misinformation that characterize the discussion of public policy and smoking can be cleared up by draw-

[1]See U.S. Department of Health and Human Services (1990).

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ing on the insights of Ronald Coase. It was Coase who pointed out in his now-famous article on social cost (Coase 1960) that, if property rights are well specified and transaction costs are zero, the costs that result from an activity are fully paid by (or internalized to) those who are engaged in it.[2] Although the Coasian conditions for complete internalization of cost are not fully satisfied in the case of smoking, or any other economic activity for that matter, they are satisfied more completely than commonly recognized. In the case of smoking, cost internalization is sufficiently complete that government attempts to increase efficiency, by internalizing the cost of smoking through taxation and regulation, are extremely unlikely to be successful.

The problem with political attempts to reduce any externalities from smoking is that the political process itself is permeated with far greater externalities. Efficient government action, just as efficient action in the private sector, requires decisionmakers who take the full cost of their actions into account. And the fact is that the Coasian conditions that lead to the internalization of costs are satisfied to a far greater degree in private settings where personal decisions on smoking are made than they are in political settings where public policy decisions on smoking are made.

Coase and Cost

The fundamental insight of Coase is surprisingly straightforward, given the impact it has had in economics,[3] and goes a long way in undermining the assertion that smokers do not pay their own way.

Coase pointed out that when property rights are well defined and transaction costs are zero, negotiations among the parties affected by the actions of any one of them will be complete and will result in everyone having to face the full cost of his actions. For example, even if I possess the property right to disturb my neighbors by playing loud music at any time of the day or night, I will face the full cost of doing so if my neighbors and I can negotiate with each other at no cost. Since my loud music imposes a cost on my neighbors, they are willing to pay me an amount that reflects that cost in return for my turning down the volume. If I refuse to do so, I am paying the full

[2]The typical statement of the Coase result (commonly referred to as the Coase theorem) is that when transaction costs are zero, efficiency is guaranteed regardless of how property rights are assigned. Since efficiency requires that costs be internalized to the relevant economic decisionmakers, the Coase result can also be stated in terms of internalizing costs.

[3]The impact of Coase has been particularly important in the application of economic analysis to improve our understanding of the development and consequences of the law.

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cost I impose on my neighbors by forgoing what they are willing to pay for peace and quiet.

Although the conditions that generate complete negotiations are not satisfied perfectly anywhere, they are satisfied more widely and completely than is commonly realized. It is difficult to imagine an activity in which we engage that does not impose costs on others. Yet in most cases we compensate fully those who bear those costs with the prices we pay in the marketplace.

In the case of cigarette smoking, it is obvious that Coasian negotiations through market exchange internalize all of the direct cost of smoking to the smoker. Those who incur the costs necessary to produce the ingredients that go into cigarettes, transport those ingredients to cigarette factories, manufacture and package the cigarettes, and then distribute and sell them to consumers are fully compensated by the smoker when he exchanges cash for his carton.

But what about the indirect costs that are claimed to result from smoking? It is widely believed that smokers impose costs on society in general by (1) placing disproportionate demands on the health care industry, (2) reducing the productivity of the economy with excessive absenteeism, and (3) imposing environmental tobacco smoke on others. Popular opinion notwithstanding, those supposed indirect costs of smoking are either nonexistent or they are costs that are largely, if not completely, internalized by Coasian considerations.

Costs That Go Up in Smoke

In studies that have attempted to estimate the indirect cost of smoking that are supposedly paid by society in general, rather than by smokers, by far the largest estimated costs are those associated with health care and worker absenteeism. The argument is that smokers demand more health care and miss more work than nonsmokers and, therefore, impose significant and uncompensated costs on all of us. Rarely has an argument so lacking in theoretical and empirical support been so widely and uncritically accepted. The claim that smokers create external cost in the form of medical care demands and worker absenteeism simply goes up in smoke when subjected to examination.

Over their lifetimes, do smokers demand more health care than nonsmokers? There is no compelling evidence that they do. Indeed, the evidence that does exist indicates that lifetime demand for health care is unaffected by smoking. Simulation studies that consider the health care demanded in countries under the counterfactual assumption that no one smokes conclude that moving to a smokeless society

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would have no long-term effect on medical expenditures, even assuming that smoking is detrimental to health.[4] Upon reflection, that should not be surprising.

Whether we smoke or not, we all age, experience health problems, and eventually die; in the process, we demand health care. Smoking may affect the timing of the health care we demand, but there is no reason to believe that smoking affects the total amount of health care demanded.

But even if smokers do not make use of more health care over their lifetimes than nonsmokers, might it not be the case that the health care smokers demand is more likely to be subsidized than the health care that nonsmokers demand? Not if those who want to tax cigarettes and regulate smoking are correct in their belief that smoking reduces life expectancy. If it is true that smoking reduces life expectancy, then smokers are more likely than nonsmokers to demand the bulk of their medical care before the age of 65. And 65 is the age of eligibility for publicly subsidized medical treatment through the Medicare program.[5]

Worker absenteeism is the other major component of the cost that smokers are alleged to impose on others. There are statistical studies showing that smokers are absent from work more frequently than nonsmokers. For example, Rice and Hodgson (1985) conclude that smokers miss 32 percent more work than nonsmokers. Having found such statistically significant differences between the absentee rates of smokers and nonsmokers, the authors of those studies have typically concluded that smoking causes an increase in absenteeism. That conclusion is unwarranted, however, unless the study has controlled for all other factors that might affect absentee rates. For example, smokers are more likely to be found in blue-collar jobs than nonsmokers, and nonsmokers are more likely to be found in professional occupations than smokers. Since workers in blue-collar jobs miss more work on average than do those in the professions, it is not surprising that smokers miss more work on average than nonsmokers. But that information is meaningless if one wants to draw a conclusion

[4]See Leu and Schaub (1983) and Stoddart et al. (1986). Also see Tollison and Wagner (1988, chap. 4). It is true that there would be a gain in terms of present value if a reduction in smoking delayed medical expenditures. That, however, would be a transitional gain that would soon disappear.

[5]It can be argued that smokers impose costs on others through higher health insurance premiums. If that were a problem, however, insurance companies would have an incentive to charge higher rates for smokers than for nonsmokers. If they choose not to do so, then smoking is considered no different from any other category of behavior that some believe to be risky.

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about the effect of smoking on productivity. Consider the fact that pipe and cigar smokers (who happen to be disproportionately represented in the professions) miss less work, as a group, than do nonsmokers. Who would be so silly as to conclude on the basis of that information that requiring workers to smoke cigars or pipes is an effective way to reduce worker absenteeism?

In a recent study, Ault et al. (1991) have made a serious effort to examine the relationship between smoking and absenteeism by statistically controlling for such factors as age, drinking habits, sex, type of employment, and seniority. The conclusion of that study was that smoking, by itself, is not related in any statistically significant way to worker absenteeism. There is simply no empirical basis for concluding that smoking is imposing cost on society in general by causing an increase in the absentee rate of workers who smoke.

Coase in Action

For the sake of argument, we ignore the fact that empirical support is lacking for the assertions that smoking increases health care demands and worker absentee rates and ask whether those assertions, even if true, would justify government policies against smoking. As can be shown with straightforward economic analysis, the answer to that question is no. If smokers generate costs by demanding more health care or missing more work because they smoke, the Coasian conditions apply to the relevant market activity, and that activity is quite capable of internalizing the costs to those who smoke.

There is a very effective way of internalizing the cost of health care to those who make use of it, and that is to eliminate government programs that subsidize much of the health care demanded in the country. In the absence of public subsidies, the cost of providing health care would be reflected in the charges imposed on those receiving that care. There would, of course, be imperfections in a completely private health care market. But such a market would be characterized by well-defined property rights and relatively low transaction costs, so Coasian forces would ensure that the internalization of medical costs was nearly complete. Certainly, if the objective is to internalize the cost of health care, the private market performs far better than government programs.

The entire purpose of government-subsidized health care, of course, is to prevent market forces from internalizing medical costs by providing people with some minimal level of health care when they are ill, regardless of their ability to pay or of the reasons for their illness. Given that purpose, what justification can there be for

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singling out one group for a special tax because its members allegedly generate external costs by requiring more health care than others?

Next, assume for the sake of argument that smoking does cause a reduction in productivity. Would that mean that smokers are imposing external costs on society at large? The answer is a resounding no. The Coasian conditions of well-specified property rights and low transaction costs are satisfied quite well in the labor market, and, therefore, there is no reason to fear that people can avoid the costs of their low productivity by imposing them on others.

Some people are more productive than others for reasons that range from natural abilities to personal preferences, and few, if any, are as productive as they could be if productivity were their sole objective. Indeed, most people would be far less productive than they are if productivity were not rewarded in the marketplace. If a person chooses to be less productive for whatever reason, that person can expect to pay for that choice with reduced chances for promotion and lower salary than realized by those who are more productive. Indeed, the reason society can be tolerant of the freedom people have in the workplace is explained by the fact that the costs and benefits resulting from the exercise of that freedom are internalized. Without Coasian internalization in labor markets, no economically viable society could tolerate freedom in the workplace. Because of that internalization, we live in a society that recognizes that individuals, not society, are the rightful owners of their labor. If a person decides to be less productive because he chooses to smoke, overeat, pursue a time-consuming hobby, or simply indulge a preference for a less stressful life, that decision is his, not society's, to make. The effect of smoking on productivity, whatever it may be, is simply not a legitimate public policy concern.

But what about the problem of environmental tobacco smoke (ETS)? Some argue that ETS can reduce the productivity of nonsmokers in the workplace, and no one can deny with credibility that many people are irritated by ETS in public establishments such as restaurants, theaters, and airplanes. But does that cost, which is seemingly a cost smokers impose on nonsmokers, warrant government policies aimed at restricting smoking? Despite the widespread view that the cost associated with ETS does justify government restrictions on smoking, the case for such restrictions is weak at best.

The problem of ETS occurs, almost by definition, where the interacting parties are in close proximity to each other. Given that proximity, people can be expected to accommodate diverse preferences in mutually advantageous ways, with subtle social pressures and common courtesy serving much the same function as explicit

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negotiation. In recent years, attitudes toward public smoking have changed in ways that have, in effect, shifted property rights to the ambient environment away from smokers and toward nonsmokers. That shift in property rights, along with the implicit (and sometimes explicit) negotiation that takes place between smokers and nonsmokers, has made smokers more sensitive to the ETS concerns of nonsmokers than in the past (in large part because few nonsmokers have had such concerns in the past). Certainly mutual accommodation and common courtesy are strong forces for moderating the potential frictions that exist among people who engage in a large number of potentially conflicting activities.

There are Coasian considerations, in addition to those of informal social pressures, operating to internalize the costs that may result from ETS. Consider the nuisance costs that may result from cigarette smoke in a privately owned establishment, such as a restaurant. The owner of the restaurant is a residual claimant to the net proceeds generated by the restaurant. Those net proceeds are directly related to the value of the goods and services the restaurant provides to those who can, if they are not satisfied, take their patronage elsewhere. Some customers enjoy smoking while dining out, but ETS diminishes the dining experience of others. The owner of the restaurant has a strong incentive to assess the resulting benefits and costs associated with smoking in his restaurant and respond appropriately. In some cases, the appropriate response is to prohibit smoking entirely; in other cases, it is to do nothing to prohibit smoking; and in still others, it is to provide smoking and nonsmoking sections. The owner benefits from choosing the response that is best for his restaurant, and the costs of ETS are internalized to him as a residual claimant.

The same type of internalization takes place in working environments. The owner of a factory, for example, recognizes that frictions can exist among his workers for a large number of reasons, and he has every motivation to structure the work environment to accommodate those frictions at the least total cost, including the cost of the frictions. If some workers enjoy smoking at work while others object to ETS, the factory owner is the residual claimant to decisions that minimize the conflict. By appropriately weighing the costs and benefits of different policies regarding smoking in the workplace and implementing the policy that creates the greatest net value, the factory owner best serves both his interest and that of his workers.

It should be emphasized that the argument is not that residual claimants respond with perfect efficiency in internalizing the costs associated with ETS, or with anything else for that matter. But competitive pressures are constantly at work to eliminate those who are

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careless in accommodating the varied, changing, and often conflicting preferences of their customers and employees. And there can be little doubt that residual claimants in the marketplace do a far better job of responding efficiently to problems such as ETS than do remote government authorities who, when called into action, tend to impose uniform requirements on everyone. Simply put, private action does not have to hit the efficiency "bull's eye" in order to outperform government action.

Can Coase Perform in Public?

The economic case for public policies with regard to smoking is based on the argument that smoking generates external costs that should be internalized by government. That rationale rises a natural, though seldom considered, question: How effective is the government at internalizing cost?

When we attempt to answer that question, it is useful to consider how conducive the political setting is to internalizing the costs that result from public decisions. If the political process allows decisions to be made that impose uncompensated costs on some in order to provide benefits to others, then it is unlikely that public decisions will result in policy that efficiently internalizes the costs of private decisions. It may be possible at times to fight fire with fire, but it requires a tremendous leap of faith to believe that we can efficiently fight private externalities with public externalities.

We could expect the political processes to perform well at internalizing the cost of public decisions if there existed well-defined property rights in the political process that made it easy for all those affected by public decisions to negotiate with one another. Unfortunately, that is not the case. The right to political property (power) is not well defined; rather, it is allocated on the basis of competition for political influence. The advantages that come from political power have an ownership structure closer to that of common property resources than to that of privately owned resources. Those who capture access to political power are able to exploit it to promote their objectives by imposing costs on those who lack access to that power.

Those who bear the cost imposed by the political influence of others can conceivably organize themselves for the purpose of political negotiation with those who are benefiting at their expense. Ideally, the group bearing the cost could either capture the relevant political property rights and extract compensation from those receiving the benefits or offer to pay the benefiting group to reduce its political demands. In either case, such negotiations would

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internalize the cost of the political benefits to those receiving them. Unfortunately, the cost that results from the exercise of political influence is commonly spread so thinly, and over such a large group, that organizing the group to take the type of collective action required for effective political negotiation is extremely difficult. Negotiation and compromise are, of course, ubiquitous features of politics and the political process. But, such negotiation and compromise generally occur among well-organized interest groups that decide just how much political advantage each will receive at the expense of a large, and unorganized, segment of the public. That is not Coasian negotiation of the type that internalizes costs. Rather, it is negotiation over who gets to benefit most from externalizing cost.

Although relatively small groups with an overriding purpose are far easier to organize than large groups with no common purpose, there are difficulties associated with organizing any group for political action. From the perspective of an individual member of a group, the connection between his or her political involvement in support of the group's objective and the benefits received from that involvement is tenuous, and political apathy is the usual response.[6]

The attraction of political apathy is strong and not overcome easily. People seldom become politically exercised over the prospect of obtaining an incremental increase in some commonplace advantage. The most effective way to galvanize people into an active political group is by appealing to their sense of passion and virtue. Noble causes, moral crusades, nonnegotiable demands, and strong emotions fuel successful political movements. Such movements typically require an enemy whose evil designs are seen as a threat to that which is righteous. Those who stand for virtue cannot think of cooperating with the enemies of virtue to advance the interests of both. The only acceptable objective is to vanquish evil regardless of the cost to either side. The greatest political mileage is achieved with arguments that minimize the acceptability of tradeoff, negotiation, and Coasian compromise.[7]

Certainly, smoking has been politicized by those who see it as an evil and government sanctions as the most convenient way to discourage it. That politicization has not served to promote the Coasian interaction between smokers and nonsmokers that could serve the interest of both. Smokers are a large and diverse group with

[6]The classic statement of that temptation to be a free-rider in a group setting is given by Olson (1965).

[7]For a more extended discussion of the contrast between political and market incentives as a means of avoiding such social hostility, see Lee (1982).

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no overriding common concern. The sheer number and diversity of smokers explain why they are far less organized, if organized at all, than such groups as the American Heart Association, the American Lung Association, and the American Medical Association. Those groups consist of relatively small numbers of people who are motivated by focused objectives that are promoted by political action against smoking.[8] The ability of such antismoking groups to obtain their objectives through their organized political influence, coupled with the political impotence of smokers, rules out any expectation that Coasian accommodation between antismokers and smokers can be realized through the political process.

It can be argued, of course, that smokers are represented by the political activities of the tobacco industry, which is able to organize for political action. Without embracing the proposition that the advantage of smokers would be advanced by the success of all political initiatives of the tobacco industry, it can be said that there is a significant amount of correspondence between the interests of smokers and those of the tobacco industry. The tobacco industry favors lower taxes on tobacco products, fewer governmental restrictions on where those products can be used, and more freedom to advertise (provide information on) them. But the ability of the tobacco industry to organize for political action, and the overlap between its interests and those of smokers, does little to facilitate Coasian interaction between smokers and antismokers in the political arena.

For the reasons previously discussed, the groups that oppose smoking realize the political advantage of characterizing their opposition as a noble crusade against evil. Groups whose interests are advanced by antismoking policies are best able to mobilize political support for those policies by presenting smoking as evil and tobacco companies as profiteering promoters of evil. The rhetoric of moral crusaders best describes the pronouncements of those who want "to make the dream of a smoke-free society come true" (Koop 1988, p. 11). Examples of such rhetoric are plentiful: The tobacco "industry has been fighting a war against the public" (White 1988, p. 232). "Like a cancer that has metastasized, the cigarette companies have spread throughout the American economy" (White 1988, p. 232). "How has such an unmitigated evil as tobacco become so entrenched in our society?" (Lee 1989). "[The tobacco industry] should be treated like

[8]Although groups politically organized around public health issues find it convenient to present their activities as noble quests for the common good, there are reasons for believing that narrow private advantage is an active motivating factor behind public health—and antismoking—lobbying. See Tollison and Wagner (1991) and Bennett (1990).

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the Medellin [drug] mafia" (Pertschuk 1989). "Tobacco company executives are mini-Adolph Eichmanns" (Daynard 1987). "Any [favorable] advertising is inherently deceptive of a product [tobacco] . . . which is guilty of all these sins" (Lukens 1990, p. 15). "People who work for tobacco companies have no reservations about killing people" (McNutt 1990).

Rhetoric such as that, and the emotional and moral certitude it evokes in the faithful, all but eliminates any possibility for mutually advantageous give and take. With little scope for Coasian compromises between competing interests, the political interaction between smokers (as represented by the tobacco industry) and antismokers becomes a negative-sum struggle. The only way the interests of committed antismokers can be advanced is at the expense of the tobacco industry and smokers. When a decision is made that goes against the antismokers, they feel not just disappointment and frustration but a righteous indignation at the evil that has been allowed to prevail. The process can, as demonstrated by the rhetoric of the most committed antismokers, degenerate into a malicious exercise in which the major preoccupation becomes inflicting harm and ridicule on the enemy.

Comparing the private interaction between smokers and nonsmokers in the marketplace with their public interaction in the political arena leads to the conclusion that Coase performs far better in private than in public. Indeed, in the case of smokers and nonsmokers, the reasonable conclusion is that Coase refuses to perform in public.

Conclusion

Individuals can be depended on to pursue their own advantages as they see them. Unfortunately, in our world of scarce resources and diverse preferences, the advantage of each is always in potential conflict with the advantage of others. The only hope for a productive and harmonious social order is in social institutions that reveal to people the costs their activities impose on others, and then motivates them to take those costs into consideration. Fortunately, the institutions of private property and markets generate exactly that type of revelation and motivation. With private property and markets, the Coasian condition of low transaction costs is satisfied sufficiently. The costs generated by activities are internalized to those who benefit from engaging in them. Perfection is, of course, an impossible dream, but for most activities, most of the time, the guidance provided by Coasian cost internalization generates private interaction,

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which is amazingly harmonious given the potential for conflict that exists in all human activity.

Regardless of how well private incentives internalize costs and harmonize social interaction, it is always possible for some to enhance their well-being by overriding private choices with political choices. Indeed, the advantage often seen in political action derives from the fact that private choices are being disciplined effectively by Coasian cost internalization. Such cost internalization, while promoting an efficient compromise among many competing interests, invariably leaves it possible to further advance the interests of some by allowing them to impose uncompensated costs on others. Often a group that has enough political influence can do just that by politicizing an issue. For example, by politicizing the issue of smoking, those who oppose smoking are able to promote their objectives by using the government's regulatory and taxation powers to impose uncompensated costs on those who smoke.

Private-sector incentives are doing a far better job of internalizing the costs that smokers generate than most people recognize. Furthermore, the same private-sector incentives also internalize the costs created by those who desire a reduction in smoking. In a Coasian setting, cost is reciprocal, and just as smokers have to accommodate the desires of nonsmokers, so nonsmokers have to accommodate the desires of smokers. Obviously, nonsmokers would prefer a less reciprocal arrangement in which all of the accommodation was required of smokers. And that is just the arrangement that the more adamant nonsmokers are attempting to realize by politicizing the issue of smoking and turning it into a moral political crusade for a "smokeless society." By pitting government power against Coasian incentives, that attempt decreases both the degree to which costs are internalized in social interaction and the civility and harmony with which that interaction takes place.

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BOOK REVIEWS

Public School Choice: Current Issues/Future Prospects
Myron Lieberman
Lancaster, Pa.: Technomic, 1990, 199 pp.

Educational choice is currently America's hottest idea in school reform. Disappointed by the lackluster results of the traditional reforms aggressively adopted during the 1980s—primarily more money and higher standards—reformers have been turning to nontraditional reforms such as school-based management, political decentralization, and educational choice. In theory, choice is the most radical of the new reforms because it shifts the control of schools away from political institutions such as school boards and district offices and toward parents, students, and the schools themselves. In theory, choice counts on market forces—competition among schools for students—to stimulate the kind of improvement that political and administrative efforts have been unable to bring about. In practice, however, choice may not be successful.

The single greatest problem with choice is that it is seldom implemented in a way that makes serious use of market forces, that subjects the supply of schools to the discipline of demand. Most forms of public school choice in place today provide families with a few alternatives to their neighborhood school, but the alternatives are not determined by competition. The alternatives are still largely those that school systems, through traditional political and administrative processes, decide to provide. Public school choice is seldom structured in a way that provides schools with meaningful incentives and opportunities to compete for students or that places bad schools—schools that no one wants to attend—at risk of being closed or taken over. Public school choice, in other words, is mostly a demand side reform that does little to influence supply.

As the idea of choice sweeps the nation—eight states have adopted statewide open enrollment for public schools, another twenty are debating it, and hundreds of districts provide some form of choice—the serious limitations of most choice plans need to be better appreciated. Myron Lieberman's *Public School Choice* does a thorough job of exposing these limitations—and of explaining why the major interest groups involved in education policymaking strenuously resist choice plans that are not so limited. In straightforward fashion, Lieberman asks how well choice plans satisfy the standard assumptions that economists make about

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competitive markets. For example, how easily can new suppliers enter the educational market? The answer is not very easily. Indeed, Lieberman argues, public school choice is not really about competition at all. Public school choice fails most market assumptions.

As Lieberman persuasively shows, public school choice does not provide schools with sufficient economic incentives to seek new students. Choice plans also typically fail to provide schools with sufficient flexibility to compete. State and district regulations limit their ability to differentiate themselves from one another. And personnel rules, in statutes and collective bargaining agreements, make it exceedingly difficult for schools to create distinctive staffs through hiring and firing. Lieberman is especially insightful in discussing labor-management issues. Besides his productive academic career, Lieberman has worked as a consultant or negotiator in numerous collective bargaining processes. His knowledge of the many tensions between union objectives and school competition is impressive.

This hard-hitting and highly accessible book should jolt those reformers who so often argue that public school choice will transform American education in much the same way that markets are expected to transform socialist economies. Reformers need to be so alerted, for an educational system truly based on principles of competition and choice could bring major improvements in the organization and performance of America's schools. Yes, reformers also need to know that there are problems with markets—for example, uninformed parents, principals and teachers who are currently incapable of running competitive schools, and economic savings associated with some forms of centralized educational organization. Lieberman discusses these problems and more. Still, it would be a shame for American education if the current enthusiasm for market-oriented school reform was squandered on choice plans that do not give markets a real chance and do not provide families with real choice. Lieberman fears that such a sad scenario is a likely one, and I quite agree.

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The Political Economy of American Monetary Policy
Thomas Mayer, ed.
New York: Cambridge University Press, 1990, 314 pp.

A dramatic shift has occurred in recent decades in the thrust of academic research regarding the operations of the Federal Reserve System. Scholarly studies used to concentrate on technical aspects of Federal Reserve operations. In each of the Fed's domains—monetary policy, lender of last resort, and bank regulator—investigators asked what the Fed was doing and how it was doing it. These studies presupposed that only the public interest animated Federal Reserve activities.

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Two developments account for a new direction in academic research. First, the Federal Reserve was not responsive to critics. It defended its performance and rarely conceded past mistakes. Second, the influence of public choice theory on the analysis of the behavior of government agencies, including monetary authorities, has expanded rapidly. Public choice theory assumes that actions by public bodies are motivated by the preferences of their leaders. The theory further notes that these preferences are not necessarily limited to serving the public interest. Public servants may be more motivated by attempts to promote their institutions' franchises and their own private interests. Public choice theory leads investigators to focus on why the institution has performed the way it has.

Determining the factors that influence Federal Reserve behavior involves a multidimensional investigation. The institutional setting must be related to the policy choices the Fed makes. But the institution itself is complex and subject to both international and domestic pressures. The Fed's interactions with other central banks can affect its decisions, and domestically the Fed is an agent of Congress and is accountable to the president who appoints the board of governors and the chairman. The Treasury Department wants the Fed to be obedient to its agenda. The Federal Reserve chairman and individual governors often seek to influence the selection of district bank presidents, thus limiting the number of independent voices within the system. Political choice theory needs to trace the paths that lead from all these sources of power as well as to identify the personal motives of staff and governors in making the Fed's decisions. These decisions affect what the price level will be, whether the Fed will play the short-run Phillips curve game, under what circumstances it will intervene as lender of last resort, and what position it will maintain as bank regulator relative to its rivals in bank supervision.

The Political Economy of American Monetary Policy, edited by Thomas Mayer, includes 19 chapters that attempt to explain the Fed's behavior in light of public choice theory.

Some of the chapters reject models the literature has previously applied to the Fed. Take, for example, the bureaucratic theory that regards power and prestige as the primary goals of the Fed, eager to maximize its autonomy and the size of its staff and its budget. Power, prestige, and autonomy do seem to play a role, but Thomas Willett dismisses budget and staff maximization as significant influences on monetary policy. He similarly dismisses the theory that decisionmakers at the top levels of the Fed are engaged in significant rent seeking, but Willett notes that the extent to which Congress and the executive branch are engaged in rent seeking can have an indirect influence on Fed policy.

The nature of the relationship between Congress as principal and the Fed as a congressional agent is also in dispute. It is not clear whether Congress is a behind-the-scenes manipulator of banking regulation and monetary policy or whether Congress does not seek such control.

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Contrary to earlier studies, Nathaniel Beck provides evidence in support of the view that Congress does not seek control and shows why inactivity is in the interest of the legislators.

Although evidence indicates that executive branch pressure dominates monetary policy, Michael Munger and Brian Roberts argue that a new theory is needed that encompasses all sources of political pressure on the Fed. The executive branch supports the Fed in return for its maintenance of a desired level of nominal interest rates, and the Fed accepts the role of scapegoat for the Congress—when interest rates are rising and exchange rates fluctuating, for example—in return for relative autonomy.

The book includes chapters with contradictory findings on the validity of the political business cycle. Beck reports that M1 growth rates support the existence of a political business cycle while the federal funds rate provides no such support. Meanwhile, Willett finds evidence that a political business cycle exists based on Treasury bill rates.

Political pressure is also exerted within the Fed. Thomas Havrilesky and Robert Schweitzer attempt to determine which of eight career characteristics of members of the Federal Open Market Committee (FOMC) accounted for dissenting votes, which were discouraged, over the period 1960 to 1983. Assuming that the central government favors inflation, Havrilesky and Schweitzer attribute votes for easier monetary policies to those characteristics that indicate greater proximity to the central government. Votes for tighter policies were attributed to characteristics reflecting less proximity to the central government. In contrast to earlier results, the authors of this chapter found that occupational background did make a difference in FOMC dissents.

John Gildea presents a different model of FOMC voting behavior. He considers each member's voting record—dissents as a percentage of total votes—from 1960 to 1982. Gildea includes politico-economic constraints, individual preferences, career variables, and social-background variables. He reports results for four different samples, and he concludes that members voted for more expansionary monetary policy as presidential popularity declined and as the ex ante real interest rates rose relative to inflation. Governors cast their split-decision votes in accordance with the appointing president's party. Voting behavior accommodating short-run political pressures was associated with government experience and private industry background; voting behavior resistant to such pressures was associated with an Ivy League education, an economics Ph.D., and a position as a regional Federal Reserve Bank president.

Thomas Mayer offers a mirror-image of public choice theory. He argues that the Fed is driven less by the wish to enhance power than by attempts to avoid feelings of responsibility when policy turns out to be mistaken. Mayer labels his approach a regret-avoidance theory, on the basis of a psychological phenomenon called cognitive dissonance. He cites behavior that suggests the Fed may be seeking to reduce cognitive dissonance, but Mayer notes that other explanations may be equally operative.

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Two chapters deal with the Federal Reserve as a political power. The Fed's power arises from its control of monetary growth, its regulatory functions, and its role as lender of last resort. James Pierce shows how the Fed has worked to increase its power. This has been illustrated most recently by the Fed's opposition to recommendations that would limit its supervision to large (rather than all) bank and thrift holding companies. Edward Kane discusses the incentives of the Federal Reserve and Congress to avoid accountability. Efforts to impose a rule on the Fed in place of current discretionary policy will not succeed, Kane concludes, unless the shift is accompanied by some sort of compensation for those who would lose by the reform.

In some remaining chapters, the authors either do not draw political implications or they tack them onto essentially apolitical material. One chapter provides a Marxian explanation for Fed behavior, and its inclusion is a mark against the editor's judgment. According to Gerald Epstein and Juliet Schor, the Fed is inflation averse because it is primarily concerned not with the public's welfare, but with financial and nonfinancial profitability, which is reduced by inflation.

If judged by this collection, public choice theory as applied to the Fed lacks overall structure. Individual research findings relate to a particular aspect of the subject. Interesting as the explanations are, they offer only partial insights at best, and they are limited to the time and circumstances to which they apply. As a result, none of the explanations is fully persuasive.

The one attempt at structure is the chapter by Robert Hetzel, who provides a theoretical framework for the Fed's discretionary monetary policy. In this framework, congressional desires to redistribute income through inflation are constrained by the obvious costs of inflation. Congress can pressure the Fed for expansionary monetary policy without accepting responsibility for inflation because it has given the Fed nominal autonomy. The Fed for its part chooses procedures that defend its institutional autonomy while allowing it to provide the trend rate of inflation the political system demands. More structured public choice studies are a promising direction for future research.

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The Economics of Property Rights: Towards a Theory of Comparative Systems
Svetozar Pejovich
Boston: Kluwer Academic Publishers, 1990, 204 pp.

It is now generally recognized that socialist economies have failed to deliver on their promise of a more equitable and prosperous society. It is also generally recognized that the economic failure is a consequence of socialism's inability to provide the information and incentives necessary for the efficient allocation of resources. Despite the fact that the

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argument concerning the perverse consequences of collective ownership can be traced back to Aristotle, many economists have failed to appreciate the depth of the analytical insights that follow from pursuing a property rights approach to social and institutional questions.

Steve Pejovich can take a lot of credit for making the economics profession take notice of the theoretical and empirical power of the property rights paradigm. Beginning with his work on the Yugoslavian system of workers' self-management and continuing with his more recent work on the Soviet reforms, Pejovich has consistently chided fellow economists for not paying enough attention to the consequences of alternative institutional arrangements for economic decisionmaking.

In *The Economics of Property Rights*, Pejovich continues his reconstruction of economic thinking on alternative systems. The book contrasts the operation of capitalism with that of socialism. Pejovich combines theoretical discussion with historical illustrations in a very convincing manner. The book, however, attempts to cover a lot of ground—from the impact of religious thought on economic ideas to the analysis of concrete proposals for reform—in a relatively few pages. As a result, the book is divided into 19 brief chapters, and one is often left wishing that each particular subject was treated in more depth. Nevertheless, the work summarizes and synthesizes several important contributions to economic theory and history.

Part One (chapters 1–3) introduces the reader to the basic notions of scarcity and competition and describes how alternative social institutions arise to cope with the problem of allocating scarce resources among alternative uses. The historical development of capitalism, as well as the intellectual history of socialism, are explored in two brief chapters (2 and 3).

Part Two (chapters 4–9) is devoted to an analysis of capitalism. In this section, Pejovich explains how the institution of private property and free-market pricing mobilizes and signals economic actors to allocate resources efficiently. Chapter 9, in particular, explains neatly the vital role financial markets play in the intertemporal allocation of resources.

Part Three (chapters 10–16) analyzes the Soviet-type economy. Unfortunately, Pejovich does not always fully grasp the radical implications for the Soviet economy suggested by his own work. He repeats many of the historical myths concerning the origin of the Soviet system, the experience of "war communism," and the establishment of the Stalinist system. Even a more fundamental problem, though, is his failure to appreciate the true nature of the Soviet "planned" economy. If socialist planners lack both the information and incentives to rationally plan the economy, then what do they do? On the one hand, they can attempt to plan in the absence of any market signals and can misallocate scarce resources. Or they can substitute political for economic rationales as a criterion for the allocation of resources. The consequences of such a substitution is what Michael Polanyi has called "conspicuous produc-

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tion." Planner's preferences take precedent over consumers. While Pejovich clearly recognizes this, the insights of Polanyi, G. Warren Nutter, Paul Craig Roberts, and Eugene Zaleski concerning the polycentric nature of the Soviet economy could have been conveyed with more power and conviction. Nevertheless, Pejovich correctly sees the Soviet economy as a system of monopoly privileges governed by the *nomenklatura*.

His chapters on the Soviet-type economy, therefore, represent a mixed bag. Chapter 12 on the basic institutions of Soviet planning is not as strong as it could be, but chapters 13, 14, and 15 contain important theoretical and empirical observations about the operation of the Soviet system. Pejovich's most important contribution in these chapters is to force economists to analyze the implications of the fact that "public ownership" is merely a "facade" hiding the fact that the Politburo has traditionally been the true owner of all nonhuman resources in the Soviet economy. Recognition of this fact forces analysts to pay attention to the way the Soviet system actually works, rather than focusing on how the central-planning text-book models say it is supposed to work. Understanding the actual—implicit and de facto—operation of the Soviet economy is a vital prerequisite to understanding the necessary and sufficient conditions of transformation of the system and the pressures that will come to bear on those efforts.

Part Four (chapters 17–19) provides a property rights perspective on the labor-managed economy. These chapters summarize much of the work that made Pejovich and Furubotn famous. As they have pointed out, labor-managed economies tend to favor current consumption over savings, thus retarding capital investment and innovation. Moreover, these economies are biased against employing additional workers since all workers share in their firms' earnings, but new workers did not participate in financing the additional capital. As a result, the high unemployment rate observed in labor-managed economies is a structural result of the institutional design of labor management.

The Economics of Property Rights is recommended reading to all students of economic systems. Pejovich has provided a useful summary of the findings and implications that follow from studying economic decisionmaking under alternative rules of the game.

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Friedman in China
Milton Friedman
Hong Kong: The Chinese University Press, 1990, 144 pp.

Milton Friedman, Nobel laureate and the intellectual leader of the revival of monetarism, has again attempted to unlock the mystery of money for us in his new book *Friedman in China*. As the title indicates,

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the book reflects Friedman's thoughts on China on the basis of his knowledge of Western market economies. During his two visits to China in 1980 and 1988, Friedman gave a series of lectures and, on his second visit, met General Secretary Zhao Ziyang. These lectures form the main content of the book. One chapter is devoted to the dialogue between Friedman and the general secretary. Steven Cheung's reminiscences of Friedman's second visit to China are also included in the book.

In the years between Friedman's two visits, China undertook first agricultural reform and then industrial reform. Lands formally owned by communes were divided and leased to households for 50 years. Each household was responsible for its own output. Output in excess of a government-mandated purchase could be sold at free-market prices. The so-called "household responsibility" system soon created a miracle: Food was suddenly abundant in most parts of China, and millions of peasants were released from their lands through the dramatic increase in efficiency. Between 1980 and 1985, agricultural output grew at an annual rate of 8.2 percent, compared to an annual rate of 3 percent between 1952 and 1977. The "surplus labor" released from the countryside was either absorbed by newly formed county and township enterprises or laborers migrated to big cities and coastal areas looking for a better life.

As the wave of economic reform swept to industrial sectors, however, Deng's blueprint for economic reform began to face some real challenges. The "managerial responsibility" system, which was copied from the household responsibility system, was not as successful as its predecessor. After all, managers and workers in a state enterprise are not household members who want to work together to improve their well-being. Besides, according to Marxist doctrines, workers are supposed to be the "owners" and managers are the "servants" of state enterprises. Therefore, the interests of managers and workers may not be the same. As local government officials and enterprise managers were granted limited power in making decisions on production and revenue-sharing, they tended to use the power to benefit themselves. So, the interests of local governments and enterprises also clashed with the interests of the central government. Although industrial output grew at an annual rate of 16.6 percent between 1985 and 1988, the central government revenue, as a percentage of national income, actually decreased by more than 4 percent during the same period.

Moreover, as local government officials and state enterprise managers enjoyed increasing autonomy, they soon realized that it was to their mutual benefit to get more loans from either the central government or the local branches of the People's Bank of China, which is China's central bank. More loans meant more revenue to local governments and a larger share of the nation's economic pie that belonged to nobody. In this sense, China's bank loans have become government grants that represent no risk to state enterprises at all. As total outstanding loans dramatically

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increased, the People's Bank of China was forced to inject more money to ease the liquidity shortage. Inflation then soared. According to the official consumer price index, inflation was 7 percent in 1986, 9 percent in 1987, and 21 percent in 1988, the time when Friedman was in China.

Although China's central bank recognized that "substantial inflation is always and everywhere a monetary phenomenon," it apparently lacked the ability to control the money supply. Because of public ownership (i.e., both banks and enterprises belonged to the state), money could be created either from the top as the central government demanded more spending or from the bottom as local governments and their subordinated enterprises competed for more loans in an effort to expand their shares of the nation's income. Since the nation's total income did not change overnight, money soon lost value as inflation rose.

Besides the issues of inflation and property ownership, many other thorny issues also began to surface in the process of industrial reform. These issues included, for example, how to use the market mechanism in connection with central planning, how to disentangle the relationship between state-owned banks and state-owned enterprises, whether to pursue economic reform drastically or gradually, and whether to relax exchange rate controls and eliminate the two-tier price system. Friedman has elaborated these issues, not only persuasively and eloquently, but also simply. Therefore, this 144-page book is suitable for anyone interested in economic reforms in either China or other countries trying to make the transition from central planning to a free market.

Three years after Friedman's second visit, China began to loosen control on foreign exchange rates and to allow prices of many commodities to be determined in markets. Stock markets were established in both Shanghai and Shenzhen, and future markets on certain agricultural commodities were emerging in some areas. All these changes indicate that China is again moving solidly toward market-oriented reforms. But these markets are neither "free" nor "private." Furthermore, the central government is again tempted to use the cheap way to lift China's sagging economy—printing money, this time under the sacred name of the Keynesians. By the end of the third quarter of 1990, the money supply was growing at an annual rate of 20 percent, the highest level since the last quarter of 1988, and Chinese officials have attributed the rebound of industrial production in 1991 to their successful effort in "fine tuning" the economy.

Alas, I begin to wonder if the Chinese officials still remember Friedman's advice and whether they know why Friedman is so famous.

Jeffrey Liang
American Enterprise Institute

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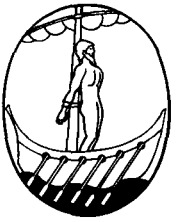

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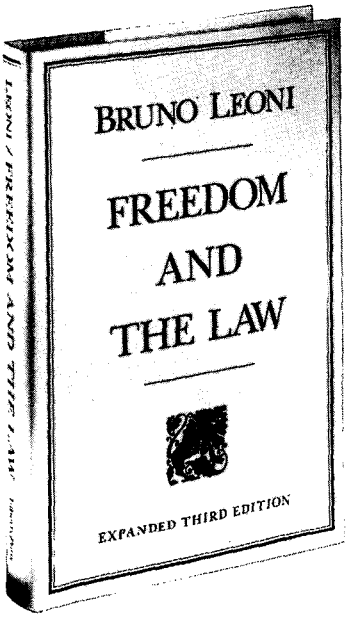

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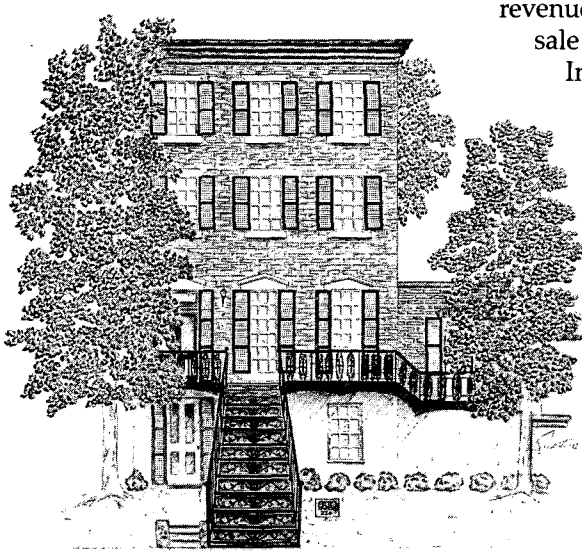

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Adam Smith's argument for the use of the market for the organisation of economic activity is much stronger than it is usually thought to be. The market is not simply an ingenious mechanism, fueled by self-interest, for securing the co-operation of individuals in the production of goods and services. In most circumstances it is the only way in which this could be done. Nor does government regulation or operation represent a satisfactory way out. A politician, when motivated by benevolence, will tend to favour his family, his friends, members of his party, inhabitants of his region or country (and this whether or not he is democratically elected). Such benevolence will not necessarily redound to the general good. And when politicians are motivated by self-interest unalloyed by benevolence, it is easy to see that the results may be even less satisfactory.

The great advantage of the market is that it is able to use the strength of self-interest to offset the weakness and partiality of benevolence, so that those who are unknown, unattractive, or unimportant will have their wants served. But this should not lead us to ignore the part which benevolence and moral sentiments do play in making possible a market system.

—R. H. Coase

"Adam Smith's View of Man,"
Journal of Law and Economics
19 (October 1976): 544.

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